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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 254

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

vs.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

PETITION FOR CERTIORARI FILED JULY 25, 1942

CERTIORARI GRANTED OCTOBER 12, 1942

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IN THE

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA.

No. 8074.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., *Petitioners*,

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent*.

Petition for Review of Order of Securities and Exchange Commission.

APPENDIX TO BRIEF FOR PETITIONERS.

A **Petition for Review of Order of Securities and Exchange Commission.**

(filed October 22, 1941)

To the United States Court of Appeals for the District of Columbia:

The petition of Chenery Corporation, H. M. Erskine, R. H. Neilson, W. A. Culin, F. T. Tansill, H. D. McHenry, T.

H. Wiggin, C. M. Chenery, J. N. Greene, H. G. Calder, C. P. Rather, William E. Matthews, H. C. van den Berg, Jr., W. R. Edwards, Watson Dark, E. C. Deal, F. R. Harris, and E. C. Elliott, (hereinafter called "the petitioners") respectfully represents:

(1).

The Nature of the Proceedings as to Which Review Is Sought.

Petitioners are stockholders of Federal Water Service Corporation, and seek review of an order issued by the Securities and Exchange Commission September 24, 1941, in certain proceedings entitled "In the Matter of Federal Water Service Corporation, Utility Operators Company, Federal Water and Gas Corporation, File Nos. 34-9, 34-41, 70-28 (Public Utility Holding Company Act of 1935)". The nature of these proceedings is more fully set forth in Part (2) hereof.

(2).

The Facts and Statutes Upon Which Jurisdiction Is Based.

(A) Federal Water Service Corporation, a Delaware corporation (hereinafter called Federal), is a holding company owning securities of subsidiaries which operate water, gas, electric and other properties. November 8, 1937, Federal registered with the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935, and since said date has been a registered holding company as therein defined. November 8, 1937, Federal also filed with the Securities and Exchange Commission, pursuant to Section 7 of said act and the rules of the Commission, an application for a report on a plan of reorganization, and declarations regarding the alteration of rights of holders of outstanding securities and the solicitation of consents. The application and declarations set forth a

plan for the voluntary reorganization of Federal, to be accomplished by amendment to its certificate of incorporation pursuant to Section 26 of the Delaware Corporation Law, and by a reduction in its capital pursuant to Section 28 of the Delaware Corporation Law. At the time of the filing of the application and declarations, Federal had outstanding six classes or series of stock: $7, $6.50, $6, $4 series preferred stock, Class A stock and Class B stock. Dividends in arrears had accumulated on all series of preferred stock and upon the Class A stock. Federal had valuable assets and had substantial annual net income, but, by reason of earlier losses and depreciation in the value of investments, the corporation had a capital deficit which under Delaware Law prevented the payment of dividends. The directors of Federal desired to simplify its corporate structure and to eliminate the capital deficit by reduction of capital, and thus to enable the corporation to resume the payment of dividends.

(B) The Commission objected to the plan first proposed, new plans were filed, and continued discussions were had with representatives of the Commission toward the development of a plan which the Commission would permit to become effective under the Public Utility Holding Company Act of 1935, which would comply with the Law of Delaware as to the rights of holders of preferred stock to arrears of dividends, and which would also command the necessary consent of the stockholders of Federal as required by Delaware Law. After the decision on January 16, 1940, in *Havender* v. *Federal United Corporation*, 11 A. (2d) 331, which established that under Delaware Law preferred stock together with dividends in arrears thereon might be converted into new securities through a merger, Federal filed with the Commission on March 30, 1940, amendments to its application and declarations, setting forth a new plan of reorganization by way of merger. These amendments proposed the merger into Federal of two other Delaware corporations, Utility Op-

erators Company and Federal Water and Gas Corporation. Utility Operators Company, the stock of which was largely owned by officers and employees of Federal and its subsidiary companies, owned all of the Class B stock of Federal. Federal owned all of the stock of Federal Water and Gas Corporation. Utility Operators Company and Federal Water and Gas Corporation also filed with the Commission declarations regarding the alteration of the rights of the holders of their securities in accordance with the proposed merger agreement.

(C) During the period from November 8, 1937, to June 30, 1940, the petitioners purchased preferred stock in Federal in amounts as follows:

	Shares		
	$6.00	$6.50	$7.00
Name	Preferred	Preferred	Preferred
Chenery Corporation	3800	3547	1211
H. M. Erskine	25	50	—
R. H. Neilson	10	—	—
W. A. Culin	50	110	—
F. T. Tansill	—	65	—
H. D. McHenry	—	75	15
T. H. Wiggin	50	30	—
C. M. Chenery	150	170	—
J. S. Greene	45	—	—
H. G. Calder	—	40	—
C. P. Rather	110	310	—
Wm. E. Matthews, III	—	65	—
C. van den Berg, Jr.	25	1535	140
W. P. Edwards	100	—	—
Watson Dark	5	160	60
E. C. Deal	85	—	—
F. R. Harris	130	173	40
E. C. Elliott	27	—	—

E C. M. Chenery sold 125 shares of the $6.00 preferred stock and 20 shares of the $6.50 preferred stock, and C. van den Berg, Jr., sold 25 shares of the $6.00 preferred stock and 700 shares of the $6.50 preferred stock. When these purchases and sales were made the petitioners other than Chenery Corporation were officers or directors of

Federal or of Utility Operators Company. Petitioner Chenery Corporation is a family holding company which had nine stockholders, of whom two, who owned approximately 47% of the stock of Chenery Corporation, were officers or directors of Federal or Utility Operators Company. All of these purchases and sales of stock in Federal were currently reported to the Commission by the purchasers as required by Section 17 of the Public Utility Holding Company Act of 1935.

(D) June 29, 1940, the Commission issued tentative findings in which the question was raised for the first time whether the preferred stock which had been purchased by officers and directors of Federal or Utility Operators Company and by Chenery Corporation while plans of reorganization were pending before the Commission should be treated on any different basis from other preferred stock. Hearings were had on this question, and testimony was introduced establishing that all such stock had been purchased through brokers in the over-the-counter market at prices prevailing from time to time, except 2700 shares acquired by Chenery Corporation from an investment banking house in exchange for debenture bonds of Federal. A partner of the investment banking house testified that he was fully acquainted with the value of the stock and bonds, and that it had been a most satisfactory trade.

C. T. Chenery, the President of Federal, testified that he had advised the purchases of preferred stock of Federal by the Chenery Corporation and by the individual officers and directors, because he believed that the preferred stock was a very good investment, and because by its purchase the management could maintain a voting interest if the B stock should be eliminated.

(E) March 24, 1941, the Commission filed formal findings and an opinion in the proceeding. The plan then under consideration had contemplated the conversion of the four classes of preferred into new common stock. The Commission stated that the plan could not be approved in so far as it provided for participation of the preferred

shares purchased by officers or directors of Federal or Utility Operators Company, or by the Chenery Corporation, after November 8, 1937, on a parity with other shares of preferred stock of the same class. The Commission found that "the provisions for participation by the preferred stock held by the management result in the terms of issuance of new securities being detrimental to the interest of investors and the plan being unfair and inequitable". Entry of an order was deferred, and it was stated that further consideration would be given to the matter if Federal filed amendments to its proposed plan designed to cure this and other alleged defects therein.

(F) Thereafter amendments to the declarations and applications were filed by the corporations in order to present a plan which complied with the findings and opinion of the Commission. The proposed merger agreement was amended to provide among other things that no shares of common stock of the surviving corporation should be issued for the shares of preferred stock of Federal purchased since November 8, 1937, by Chenery Corporation or by the individual petitioners when they were officers or directors of Federal or of Utility Operators Company, but that each such purchaser should receive upon surrender of such stock to the surviving corporation the cost of such stock with interest at 4% per annum from the dates of its purchase to the effective date of the merger agreement. It was further provided in effect that the petitioners should account to the surviving corporation for any profit realized on any such stock as had been sold by them.

(G) August 15, 1941, the petitioners filed an application for leave to intervene in the proceedings before the Commission, and objected to the approval of any plan of reorganization containing a provision to the effect that the preferred stock purchased by the petitioners should be treated on a less favorable basis than other preferred stock of the same class. The petitioners contended that the entry of an order approving a plan containing such a discrimina-

tory provision would be unfair, inequitable, and detrimental to the interest of investors, and would be erroneous and illegal, and they stated that no principle of common or statutory law or of equity forbade directors or officers of a corporation from purchasing stock therein, whether or not an application contemplating reorganization was under submission to the Securities and Exchange Commission. They prayed that their application to intervene should be allowed, and that they should be made parties to the proceeding, that they should be permitted to file briefs and make oral argument, that the case should be reconsidered by the Commission to the extent that the holding then in effect treated stock held by the petitioners on a different basis from other preferred stock, that the Commission should enter findings and an opinion to the effect that the plan should be modified so that these petitioners should be treated in the same manner as other holders of preferred stock, and that the Commission should deny effectiveness to the declarations filed in the proceedings unless they should be so modified.

(H) August 18, 1941, the Commission ordered that the petitioners be permitted to intervene and become parties to the proceeding, and gave leave to file briefs. Leave to make oral argument was denied, subject to further order after consideration of the briefs. August 28, 1941, the petitioners filed a brief in support of their contentions.

(I) September 24, 1941, the Commission made a report on the amended plan of reorganization, entered supplemental findings and opinion, and issued an order permitting the declarations, as amended in conformity with the Commission's opinion of March 24, 1941, to become effective, and granting the applications as amended. This petition is filed for review of this order.

(J) This Court has jurisdiction to review the said order of September 24, 1941, under Section 24 of the Public Utility Holding Company Act of 1935, 49 Stat. 803, 15 USCA Sec. 79.

(3).

The Relief Prayed.

These petitioners pray that this Court review the order of the Commission of September 24, 1941, and that said order be modified or set aside to the extent necessary to treat these petitioners on the same basis as other holders of preferred stock of Federal of the same class. The petitioners ask such other relief as this Court may deem appropriate.

(4).

The Points on Which the Petitioners Intend to Rely.

1. No rule of common law or equity prohibits the purchase of stock by an officer or director, nor does any statute prohibit such purchases. When the purchases involved in these proceedings were made no regulation of the Commission indicated that they might be objectionable to the Commission.

2. Section 17 of the Public Utility Holding Company Act of 1935 deals with purchases of stock by officers or directors. The section provides for reports thereon to the Commission and for recovery by the corporations of profits made by such officers and directors from sales within six months of purchase. The absence of any further requirement, prohibition or penalty in a statute dealing with the subject shows a Congressional intent to permit officers and directors to purchase such stock freely to the extent such purchases are not affected by the statute.

3. Purchases of stock by officers and directors should be encouraged, whether or not the corporation is in process of reorganization.

4. The order of the Commission approving a plan of reorganization containing a provision that the preferred stock purchased by the petitioners should be treated on a less favorable basis than other preferred stock is unfair and inequitable, is detrimental to the public interest and the interest of investors (including these petitioners), is in viola-

tion of the Public Utility Holding Company Act of 1935, and of Delaware Corporation law, and is erroneous and illegal.

5. Treatment of the petitioners on the same basis as other holders of preferred stock would not be unfair, inequitable, or detrimental to public interest or the interest of investors.

Respectfully submitted,

CHENERY CORPORATION,

H. M. ERSKINE,
R. H. NEILSON,
W. A. CULIN,
F. T. TANSILL,
H. D. McHENRY,
T. H. WIGGIN,
C. M. CHENERY,
J. N. GREENE,
H. G. CALDER,
C. P. RATHER,
WILLIAM E. MATTHEWS, III,
C. VAN DEN BERG, JR.,
W. R. EDWARDS,
WATSON DARK,
E. C. DEAL,
F. R. HARRIS,
AND E. C. ELLIOTT,

By SPENCER GORDON,
Attorney.

SPENCER GORDON,
WM. MERRICK PARKER,
WM. DUBOSE SHELDON,

COVINGTON, BURLING, RUBLEE,
ACHESON & SHORB,
Union Trust Building,
Washington, D. C.,
Attorneys for Petitioners.

K DISTRICT OF COLUMBIA) ss.

Spencer Gordon, being duly sworn, says that he is one of the attorneys for the petitioners and that he makes this affidavit in their behalf because the petitioners are non-residents of the District of Columbia, that he has prepared the foregoing petition from information obtained from the records of the Securities and Exchange Commission and that he verily believes that the statements therein contained are true.

SPENCER GORDON.

Subscribed and sworn to before me this 22nd day of October, 1941.

S. WILLIAM MILLER,
Notary Public, D. C.

. . . . . .

EXCERPTS FROM TENTATIVE FINDINGS OF COMMISSION.

(June 29, 1940)

3417 The present plan of reorganization, like the previous ones which have been filed with us over the past several years, was formulated by the management of Federal Water Service Corporation, and discussions regarding the reorganization of this corporation have been taking place between the management and the staff of this Commission over the past several years. Such management has been entrenched in its position of management by virtue of the voting power of the otherwise worthless class B stock,[14] and the extended discussions which have taken place between the management and the staff of this Commission have been largely concerned with the question of what treatment could be accorded the class B stock in the light of the standards of the Public Utility Holding Company Act

[14] As we have seen, substantially all of the outstanding stock of Utility Operators Company, which owns all of the class B stock of Federal Water Service Corporation, is owned or controlled by officers and employees of Federal Water Service Corporation and its subsidiaries. C. T. Chenery and other officers and directors of Federal Water Service Corporation own or control about 23.8% of the stock of Utility Operators Company.

of 1935. Under these circumstances we think it appropriate to note that of the 8,082 shares of preferred stock as of March 31, 1940 owned or controlled by C. T. Chenery 5,918 shares, or 73.2% thereof, were acquired by Mr. Chenery or by Chenery Corporation, which he controls, since November 8, 1937 and 3,864 shares, or 47.81% thereof, were so acquired since May 12, 1939. These purchases (which we presume were made in the open market although the record does not so show) were made at prices ranging from 16½ to 36½. Very few of the shares were purchased at a
3418 price higher than 30 and substantial quantities were acquired at prices in the lower twenties. Other officers and directors of Federal Water Service Corporation have acquired 2,379 shares, or 86.7% of their present holdings of preferred stock since November 8, 1937. Persons who are officers and directors of subsidiaries, but not of Federal Water Service Corporation, have acquired all their present holdings of the latter's preferred stock, amounting to 1,605 shares, since March 30, 1937.

The following table shows the preferred stock holdings as of March 30, 1940 of C. T. Chenery, other officers and directors of Federal Water Service Corporation and its subsidiaries, and Utility Operators Company:

TABLE VI.

	Total Preferred Shares	Shares of Each Issue of Preferred			
		$7.00	$6.50	$6.00	$4.00
C. T. Chenery *	8,082	1,080	2,933	3,970	99
Other officers and directors of Federal Water Service Corporation and its subsidiary companies	4,350	415	3,203	732	—
Utility Operators Company	6,536	941	2,248	3,316	31
Totals	18,968	2,436	8,384	8,018	130
Per cent of total now outstanding	11.91%	15.93%	12.00%	11.18%	5.46%

3419 Based upon principles recently expounded by the Supreme Court of the United States[15] the Circuit

* Including preferred owned by Chenery Corporation, a personal holding company.

[15] "*Pepper* v. *Litton*", 60 S. Ct. 238.

Court of Appeals, Seventh Circuit, in a recent decision[16] has held that the principal stockholder and officer of a corporation, which was in reorganization under Section 77B of the Bankruptcy Act, sustained such a fiduciary relation as precluded him from purchasing claims of creditors at a small fraction of their face value, and using them as the foundation for a claim in excess of that actually paid therefor. Such principal stockholder and officer was permitted to maintain a claim only to the extent of the consideration actually paid by him.

While it may be that the facts in the present case differ sufficiently from those in the Norcor case, *supra*, to render inapplicable here the principles there applied, we do not regard the question as entirely free from doubt.[17]

* * * * * * * * * * *

EXCERPTS FROM TESTIMONY.

Testimony of Christopher T. Chenery, July 22 and 23, 1940.

2755 Q. Mr. Chenery, before the plan now before the Commission, which was filed on March 30, 1940, was filed were you advised by Mr. Culin that he had been advised by Mr. Kennedy that the Commission had approved the filing of that plan?

Mr. Baldy: Let's put Mr. Culin on, Mr. Hubbard.

Mr. Hubbard: I withdraw the question.

Q. Now, Mr. Chenery, during the pendency of these plans before the Commission did the Chenery Corporation purchase preferred stock of the Federal Water Service Corporation? A. Yes.

Q. I show you a schedule purporting to show the purchases of preferred stock of Federal Water Service Corporation by officers and directors of Federal and Utility

[16] "*In re Norcor Mfg. Co.*", 109 F. 2d 407.

[17] It should be borne in mind that here, as is frequently the case, the discretion and judgment of the management is, as a practical matter, largely determinative not only of what kind of a plan of voluntary reorganization shall be proposed but of when it shall be proposed.

Operators Company from November 8, 1937, to June 30, 1940, and ask you if that was prepared at your re-
2756 quest or suggestion. A. It was.

Q. And it is accurate according to the records of the company and in accordance with your best knowledge and belief? A. It is.

Mr. Hubbard: I offer it in evidence.

The Examiner: Admitted.

(The schedule referred to was received in evidence as Applicant's Exhibit No. 33.)

Q. Now, Mr. Chenery, I ask you to turn to page 3 of this Exhibit No. 33, and I ask you to describe the Chenery Corporation. A. The Chenery Corporation is a family investment corporation formed in 1926. Stockholders are my three brothers, my sister, my wife, my three children, and myself.

Q. What percentage of the stock of Chenery Corporation do you own? A. I own approximately 10,000 shares of approximately 23,000 shares.

Q. Now, Mr. Chenery, why did you purchase this preferred stock? A. I purchased it—(interrupted)

2757 Q. (Interposing) Why did the Chenery Corporation purchase the preferred stock? A. Chenery Corporation purchased it on my advice. I have felt, have testified, and have told everyone who has asked me over the past years that I thought that preferred stock of Federal Water Service Corporation, over a long period of time, was sufficiently sound so that it would again pay dividends and that this would be true whether any plan of reclassification was consummated or not, that there were inherent values in the Corporation which would be reflected in the stock and that if no plan of reclassification were put through, that the accumulation of the earnings over a period of time would be sufficient to cure the deficit and dividends would again be resumed.

Also, the officers and employees of this Corporation bought the B Stock in 1932 at my suggestion and on my advice and paid approximately $600,000 for it, contracted to pay more. The situation of the Corporation since that time has improved substantially. This B Stock was bought by all classes of employees. I think more than 99 percent of officers and employees bought it and paid for it by deductions from their salaries over a three or four-year period.

The original plans for reclassification contemplated that the B stockholders would be given an opportunity to buy their way back in the Corporation, first by giving
2758 them a special stock which was convertible into new common stock upon the payment of cash and which maintained their voting power over a period of years; second, by giving them options so that it was all the time contemplated that these people who held this Corporation together by contributions from their salaries and wages should not be thrown out. I have always regarded the ownership of this stock by the employees of the Corporation as one of the great assets of the Corporation.

Then the view shifted and apparently the feeling was that little consideration should be given to the B Stock and finally that none should be given to it. The voting control of the B Stock was thrown into the open market for anybody to pick up who desired it. I had knowledge first that the preferred stock was freely traded on the market, that there were any number of investment bankers buying and selling it constantly and secondly, that strong financial interests were accumulating substantial blocks of this stock.

As long as we thought that a plan would be worked out which would give the B Stock an opportunity to come back in the future, my suggestion was to those stockholders and I think I testified to this effect at the first hearing here in 1937 that they should save so that at the expiration or at the end of the period, they would be in a position to exercise the option and acquire that stock. Then when it be-

came apparent that this was not to be, a meeting was
2759 held of the B stockholders and it was their decision that they would contest any plan which worked them out completely and the suggestion was made that it would be wise to purchase such preferred stock as they reasonably could so that in the event that there was litigation and the plan was not worked out and that finally it should be held that the B stock was not entitled to anything, that these men who had held this Corporation together and who were its loyal servants would still have some position in the Corporation, some voice.

It was that consideration, as well as the feeling that the stock itself was inherently worth what was being paid for it, which prompted me to advise Chenery Corporation as well as to advise others who asked me I thought it was wise for them to buy the preferred stock.

Q. The preferred stock is bought and sold on what is known as the open market, is that true? A. That is true.

Q. Do you know whether quotations are published daily in newspapers? A. They are so published.

Q. What are the newspapers in which the quotations are published? A. The Tribune and, I am not sure, the Wall Street Journal. I know the Tribune.

Q. Were your purchases made on the market? A.
2760 They were made through dealers in the stock purchased on the open market, with one single exception, and that was a transaction under which Chenery Corporation exchanged with an investment banking firm of Ingalls & Snyder 100,000 principal amount of Federal Water Service debentures for 2,700 shares of 6½ equivalent preferred stock.

Q. That is the transaction referred to on Exhibit 33 in the last three items, is it not? A. That is so. Ingalls & Synder acted in part as a broker and part as principal there in that they sold part of their own stock or stock of their clients. They were one of the firms which I referred to who had accumulated the stock and I was told that they

had purchased for the account of themselves and their clients with the idea that it might be potential control of approximately 12,000 shares of the stock.

Q. At any time, did you discuss with any person in the S. E. C. staff the question of the Corporation's possibly buying preferred stock? A. Yes.

Q. Do you recall when that was? A. I have a memorandum on the subject.

Q. Will you refresh your recollection by looking at
2761 the memorandum? A. It was a meeting on April 26, 1939.

Q. What was the situation at that time and how did you happen to discuss it? A. We had first a meeting in Judge Healy's office; present—Judge Healy, Mr. Spencer, Mr. Levy and Mr. Kennedy, Mr. Hubbard, Mr. McHenry and Mr. Chenery.

At that time, plans were apparently stalemated. This meeting later adjourned to Mr. Spencer's office. I had never discussed any plan for the purchase of preferred stock as a method of working out a reclassification plan until this time because the plans, up until that time, had contemplated an all-common stock plan. If we had an all-common stock plan, there is no reason to sell your assets, to buy and retire preferred stock. Apparently we were stalemated on the plans which we thought were practicable at this time and I made the suggestion that we might be able to work out a reclassification plan by the purchasing and retiring of preferred stock which would involve the buying of large blocks of preferred stock. I think I had 60,000 shares in mind at that time and later suggested 30,000 shares.

I asked Mr. Spencer what he would think of such a plan and Mr. Spencer said he thought it was terrible. The Corporation prior to that time had had excellent use for its funds. Such spare funds as it had, such spare earnings as it had, it was using to buy its own indebtedness at
2762 the fraction—not as a fraction, somewhere in the 70's. It was buying preferred stock of Scranton-Spring-

brook in the 20's and had full and adequate use for its earnings.

I might correct that statement by saying we had discussed in the early days, 1937, a possible plan which would have involved as a part, a purchase of preferred stock owned by Utility Operators Company but that was not presented as a straight raising of the issue. The first time that I have either a memorandum or a clear recollection of the issue being raised was at this conference with Mr. Spencer and I think Mr. Spencer at that time added that the use of corporate funds to retire preferred stock at a fraction of its value and thereby to sweeten the position of the securities, the stocks junior to it, was entirely contrary to his thinking.

Q. Now, Mr. Chenery, during the period that the company has been a registered holding company, you had filed from time to time, in accordance with the Act, the reports of purchases and sales of any securities of the Federal Water Service Corporation? A. Made either by myself or by Chenery Corporation.

Mr. Hubbard: I call upon the Commission to produce the reports of the purchases filed by the Chenery Corporation.

(The reports were handed to Mr. Hubbard.)

Mr. Hubbard: Off the record.

(Discussion off the record.)

2763 Mr. Hubbard: I now offer in evidence the reports that have been filed with the Securities and Exchange Commission on Form U17-2 by Chenery Corporation and the individuals named upon Exhibit 33. I suggest that it be stipulated that it is unnecessary to have these forms physically marked in evidence but that, being a part of the Commission's files, they be considered part of the record in this case.

The Examiner: Off the record.

(Discussion off the record.)

Mr. Hubbard: If your Honor please, I am going to offer in evidence the Form U17 reports as received by the Securities and Exchange Commission covering purchases made by officers and directors of the Federal Water Service Corporation and we will work out a stipulation between Mr. Baldy and myself so that it will be unnecessary to have these records physically incorporated into the record of this hearing.

The Examiner: If it is to be stipulated, there is no need of having an exhibit number now.

Mr. Baldy: All right, your Honor.

By Mr. Hubbard:

Q. Now, Mr. Chenery, in the tentative findings and conclusions of the Commission, the statement is made:

"It should be borne in mind that, here, as is frequently the case, the discretion and judgment of the management is as a practical matter, largely determined what kind of
2764 a plan of voluntary reorganization shall be proposed but when it shall be proposed."

. . . . . .

What have you to say with respect to that statement?

A. I would say it just is not so.

Q. And as an illustration of the correctness of your statement, you cite this case? A. I cite this case. The management cannot suggest a plan at any time to stockholders—it can only file one with this Commission—unless and until this Commission permits it to be presented to the stockholders with its consent. So far as the plan, we have had plans held without action for two years at a time.

. . . . . .

2799 Q. Now on November 8, 1937, you filed the second plan, did you not, Mr. Chenery? A. The special stock plan?

Q. No, no, I am leaving the special stock plan. Now that is the first one you formally filed. Coming now to the

second, you formally filed— A. The first one is November 8, 1937. The second one was in May.

Q. Then on May 19, 1938, you filed an amendment which provided a plan as an alternative to the special stock plan, did you not? A. That is true.

Q. That plan called for a mere reduction of the capital represented by the outstanding shares of the several classes, did it not? A. Several classes of stock, yes, sir.

Q. What you were going to do was just reduce the capital represented by the several shares of otherwise leave them alone? A. Without any change of rights or preferences of the stock, all of its—each stock retaining all of its characteristics with the single modification of stated value applicable thereto.

Q. That would have cured the impediment to the
2800 payment of dividends? A. That would.

Q. And otherwise wouldn't have changed the shares? A. Changed any rates or preferences—would not have.

. . . . . .

2806 Q. Now the thing that is not clear to me, Mr. Chenery, is that when you later came along with the next plan, which is the one presently before the Commission, you departed from the terms and provisions of the plan we were last discussing. The present plan is an all common stock plan and the one which you had pending when the Havender case difficulty came along called for different terms and provisions.

In order that the record may show what led from one plan to another, would you explain how the present plan evolved? A. It is summarized in Answer 6, to Question 6, in the application, which I should like to read as being my answer:

(Reading) "The file with the Commission (File No. 34-9) shows that Applicant has desired for some time to
2807 reduce its capital in order that it might pay dividends. The file also shows that Applicant has for some time desired to reorganize in a manner permitted by

the Delaware Corporation Law. The recent decision of the Supreme Court of Delaware in Havender v. Federal United Corporation shows that this can be done by merger proceedings under Section 59 of the Delaware Corporation Law. Promptly after this decision was rendered by the Supreme Court of Delaware, Applicant's officers took up with the staff of the Securities and Exchange Commission a plan of reorganization through merger with Utility Operators Company and Federal Water and Gas Corporation, and this plan is the result."

Q. Well, I wasn't addressing my question to the mechanics of carrying out the plan. I just wanted to bring out why it was that the substantive provisions of the plan were changed; in other words, why the switch over to an all common stock plan. The plan that was pending, that was blocked by the Havender case, so far as being carried out in the way your counsel would like to have it carried out, as you said, wasn't in its substance the same as the present plan? A. No.

Q. And I want to bring out the reasons for the change. A. Well, it had always been the desire of the management to have an all common stock plan, and before this was a registered holding company the corporation had pro-
2808 posed to stockholders in October, 1936, an all common stock plan. In the meantime these legal difficulties had arisen. When they were cleared by this Supreme Court decision referred to, and the way apparently was open to an all common stock plan again, that was the plan which the management considered preferable, and which it suggested, and which we thought also was in harmony with the desires often expressed by the staff of the Commission.

* * * * * * * * * *

2809 Christopher T. Chenery, the witness on the stand at the hour of recess, resumed the stand for further examination, as follows:

Cross Examination (Continued)

By Mr. Baldy:

Q. Mr. Chenery, I think we have covered, after a fashion, the history of the discussions that you had with the staff regarding these various plans. All of the plans which you have filed contained some recognition for the B stock, did they not? A. Yes.

Q. In the plan presently before the Commission, the recognition takes the form of a staggered board of directors, is that true? A. Yes; it is quite attenuated consideration.

Q. Yes. That is the only consideration in the present plan? A. That is the only consideration.

Q. All of the others contained considerations somewhat more substantial, than that? A. Yes—substantially more.

Q. And is this decrease or this diminishing consid-
2810 eration for the Class B stock, as evidenced by the succession of plans filed, due to views expressed by the staff? A. Yes.

Q. And is it true to say that the question of what treatment should be accorded the Class B stock under the applicable standards of law has been one of the major topics of consideration between you and others connected with Federal and the staff? A. One of the major topics, yes.

Q. Would you say it would be in your judgment the chief topic? A. Well, I think the consideration to the A and the B were the chief topics.

I will add to that, if I may, that in a voluntary plan you had to have a plan which the stockholders would vote for, and until—so a great deal of consideration was given to what treatment, what was the minimum treatment that the stockholders would approve, the A and B stockholders.

Q. Well, do you think if you and the staff had been able to see eye to eye on the treatment that should be accorded the B stock under the applicable standards of law that the length of time that has elapsed during which you have been trying to get plans through here would be materially less?

A. Well, Mr. Baldy, since the last action of the Commission I am not sure that would have had any effect at all.
2811 I think it is entirely unpredictable.

Q. What do you mean, "the last action of the Commission"? A. Well, in the tenative findings which they have handed down.

Q. Well now, if one of the chief points of difference between yourself and the staff has been the treatment that should be accorded these two classes of stock, hadn't been a point of difference isn't it reasonable to suppose that the length of time that has elapsed would not be so great? A. Well, I don't know whether they would have found something else if that hadn't been the point, because in these tentative findings they bring up the question of the purchase of the stock as being something else which they would have to consider, and when that has been before them for years and when the ownership of this stock by us had been used by Mr. Weiner as one reason why we didn't need a staggered board, then to bring it up at this time, it seems to me we just couldn't predict what would happen under any circumstances until a final order came down in writing.

Mr. Baldy: Will you read the last answer?

(The answer was read by the reporter.)

Q. Well now, how could the stock holdings be before the Commission for years, Mr. Chenery, when a great deal of your stock has been fairly recently acquired? A.
2812 Well, this stock has been purchased over a substantial period of years. In the first hearing it was commented on, there was testimony about it. Reports have been filed monthly with the Commission showing each and every purchase. The staff has had full knowledge of it, and has used it in the arguments with us as to why we didn't need a staggered board.

Q. You mean that Mr. Weiner indicated that he thought the staggered board was not very important from your

standpoint in view of your holdings of preferred stock? A. Holdings of preferred stock of the group, yes.

Q. Yes. Did any member of the staff ever express any views to you about the propriety of your accumulating stock during the pendency of the plans of reorganization? A. I have no record of any member of the staff making any such comment to me.

Q. It is just a thing that didn't come up for discussion at all, isn't that right? A. Just a thing that didn't come up for discussion at all. It was full knowledge of all concerned.

Q. Is it true to say that your motive in purchasing the stock that you have purchased while plans were pending before this Commission was the combined motive of increasing voting power plus the expectation that it would prove a financially desirable investment? A. Yes, I think
2813 that is true. I think there is more stress on the voting power than on the investment, however.

Q. You mean from the standpoint of what motivated you? A. Yes.

Q. That was your primary motive? A. Yes, that was true.

Q. The other motive, however, was present to some extent? A. The other motive was present to some extent, yes.

Q. Now did you at any time request or recommend to any other officers or directors of Federal or the subsidiaries that they accumulate preferred stock? A. Yes.

Q. Will you describe, please, the nature of those recommendations? A. I think it was after we had been advised by the staff in 1938 that the Commission would not approve the plan, the plan then before it, the special stock plan, I thought that we were headed in for litigation with the Commission on the capital reduction plan. I contemplated the possibility that we might lose. I thought we would win, but I thought we might lose, and these officers and employees had bought this B stock on my urging and they had paid for it with deductions from their salary over a three-or

four-year period, and I did not want to see a situation in which the control of this company would be thrown
2814 in the open market and anybody with a few hundred thousand dollars can step in and pick it up. I wanted the employees if they lost the B stock to have some secondary line of defense, which I thought would be in the ownership of the preferred stock, and I said it was my view that it was sound policy for every person in the employ of the company who could spare the money to buy such preferred stock as they could carry, and that I would buy all that I could, through the Chenery Corporation.

Many of them did buy such preferred stock. In some cases groups got together and borrowed money from the bank to be paid over a period of time with which to buy this preferred stock.

In the case of Chenery Corporation, we liquidated dividened-paying securities at a loss in order to buy this stock.

The pendency of the plan, the time of the plan, had nothing to do with it. When we could sell this stock and buy up Federal preferred on pre-determined ratios, the orders to the brokers were to sell the other stock and buy Federal preferred.

Now I take full responsibility for the purchase of stock by officers and employees. I not only thought it was a sound thing for them to do, I thought it was highly desirable, not only from their viewpoint but from the viewpoint of
2815 the corporation, and I so expressed that opinion. I also said that I thought that the stock was inherently sound; that over a period of time, whether we had a plan or did not have a plan, that they wouldn't have any loss in the stock.

Q. It was your expectation they would have a good profit? A. It was my hope they would have a good profit.

Q. Wasn't it your expectation? A. At some time in the future. Whether that time was one or X years I didn't know, but I thought if this present economic system rocked

along on the present basis that some time in the future that stock would be good.

Q. Particularly if and when you succeeded in getting the capital deficit cured? A. It couldn't pay dividends until the capital deficit was cured, but it didn't require a plan to cure the capital deficit. The processes of time will do that itself.

Q. But it was your expectation that in all probability the preferred stock would have a substantial rise in market price if and when the capital deficit was cured? A. And it again paid dividends, yes; but I hadn't the foggiest idea when that would be, whether it was six months or six years, and so stated.

Q. That was because you didn't know how long it was going to take you to get through down here, was that
2816 it? A. Whether we would ever get through down here or not.

Q. Well, to what do you ascribe the fact that it's taking so long to get through down here? A. Well, I ascribe it to the changing viewpoints of the Commission. I think it is a perfectly reasonable explanation that this Commission has been, in the last year, in a constant state of flux. There have been people coming in, people going out. Each new group have had their own views of the law and what was permitted and what was prohibited. The law itself, as interpreted by the legal division of the Commission, I think has changed during the period of this thing. I think that for the first time since we got a community plan through you make a flat statement that voting power can't be recognized. I don't think they thought that was the law before; if so, the memorandums which we had are inexplainable.

I think the thing has been—it is your Commission and its conception of its law, of the law in which it operates, and its duties under that law, which have been in a state of flux and are now beginning to crystallize, and that we happened to come along with one of your first cases, one of

your most involved cases, which presented a great many problems which would be applicable to other situations, and they considered our case—not only considered how it affected us but how it might affect other companies
2817 which were either before you or which might come before you, and you are making new grounds on the trial, took your time to look at it. By the time you had come to a conclusion there would be something new developed and you would stand off and look at it again.

Now I am not critical of that. I think it's been hard on the Federal preferred stockholders. I think but for the action of this Commission that they would have had more than a million dollars disbursed to them in the last two or three years, which they were reasonably entitled to and which we could have paid, and I doubt very much that any minor changes which you make in this plan will recompense these preferred stockholders for the million dollars they didn't get—and the million dollars is an under estimate, rather than an over-estimate.

Q. But you have at no time deemed the situation of the preferred stockholders such as to warrant you in abandoning the idea that you should get something for the Class B stock? A. No. I see no—

Q. (Interposing) That is all right. That is the answer. A. I would like to amplify it, if I may, if you really want to know what I think.

Q. I think you have answered the question. A. All right.

. . . . . .

Testimony of Walter A. Culin, July 23, 1940.

2848 Q. Now, Mr. Culin, according to your Exhibit No. 33, you apparently are one of the purchasers of preferred stock of Federal Water Service Corporation. Will you state the circumstances under which you purchased that preferred stock and why you made the purchase? A. I recall that during the summer of 1938 after we had

had discussions with the staff of the Commission about reorganization plans, and in particular the reduction of the capital plans, we had discussions in our office as to the advisability of the individuals, officers and some of the employees buying preferred stock of the company.

I was in agreement with that thought both from the standpoint of wanting to strengthen our position as the management group in our voice in the company and also I believed that ultimately the stock would be of value in excess of what I would probably have to pay for it at that time.

I bought 50 shares in September 1938, ten shares in November 1938, making a bank loan to buy some of it and later on when I paid that loan I made another loan and bought some more in 1939 and January 1940.

Q. Do you have any information with respect to the pendency of the plans which you considered not available to other stockholders at that time? A. I certainly
2849 did not. I always advocated the policy that if at any time we had discussions pending before the Commission it was not the time for us to buy any stock because we might later be criticized and we were always careful when we were in the midst of what we considered to be important conversations with the Commission or the staff of the Commission, that it was not the time for us to buy the stock, that we might be criticized later. We have always been very free in giving information to everybody who asked us for it.

Q. And at various times requests were made for information from you with respect to the status of a plan? A. I have had many requests from stockholders, security dealers, and newspapers for information of the plan, and excepting at certain periods when we were right in the very midst of the discussions we have always given out all the information that was available, everything we knew about it.

Q. You have never purchased any stock at any time where information wasn't entirely available to everybody? A. I have not.

Q. What sources of information did people have with respect to securities of the Federal Water Service Corporation and their value? A. The statistical agencies carried pretty full information about the plans. Since 1937 we have had on file a great amount of detail in the S.E.C. We have always given information to various brokers and in-
2850 vestment dealers and they have published and distributed a number of memoranda about the plan and about the company, and at various times the newspapers have asked us for a release or have asked us to give them a story as to the company and its position, its finances and the status of the plan.

Q. And from time to time the Commission issued releases, did it not, with respect to plans? A. When we filed plans with the Commission they then published a release.

Mr. Hubbard: Off the record.

(Discussion off the record.)

By Mr. Hubbard:

Q. Mr. Culin, do you have something to do with the preparation of annual reports to stockholders? A. I do.

Q. And you endeavor to give stockholders all the information about the company? A. Yes.

Q. And quarterly earning statements are published in the financial pages of the newspapers, are they not? A. That is right.

Q. Newspapers carry reports of various plans from time to time, plans that are before the Securities and Exchange Commission, do they not? A. They do.

2851 Q. I think you testified that Standard Statistics give periodic reports with respect to the position of stocks? A. Yes.

Q. And from time to time various investment houses also give information and advice with respect to stock? A. Yes.

Q. The stock of the Federal Water Service Corporation? A. Yes.

Mr. Hubbard: That is all, Mr. Culin.

Cross-examination

By Mr. Baldy:

Q. Mr. Culin, will you identify the conversations that were of such character that you did not feel it would be proper to purchase stock while they were in progress? Will you give dates? A. There were discussions in the latter part of December 1937, December 16 and December 22, 1937. I would like to withdraw that answer.

I was present in discussions on December 5, December 21, and December 29, 1938.

Q. December? A. December 5, 21, and 28, 1938, and a telephone conversation on December 29.

Q. Were those conversations of the kind referred to in your direct testimony as being of such kind that
2852 you didn't consider it proper to purchase preferred stock while they were going on? A. No, because at that time there wasn't anything definite coming out of the questions.

Q. Well, my question is addressed to conversations of the kind you referred to in your direct testimony. I am asking you to identify which they were. A. On March 29, 1939, I had a telephone call from Mr. Spencer telling me that there had been informal approval by the Commission of the new plan.

Q. What date was that? A. March 29, 1939.

Q. March—what? A. March 29.

Q. Pardon me. I don't want to interrupt your answer. Just continue your answer. A. It seemed at that time that we probably would have a new plan but shortly after that further discussions with the staff indicated that we were still far apart on the plan. I refer particularly to telephone conversations of April 13, 1939.

Q. What do you mean by the plan? You said you were still pretty far apart on the plan. A. That was the preliminary discussions which ultimately led up to the plan which was filed in May 1939, which was upset by that

2853 Havender decision. The other time that I was having discussions with members of the staff, during which period I thought it would be improper to buy preferred stock, was March 1940.

I received a telephone call on March 25, 1940, from Mr. Kennedy, explaining that the Commission thought we should go ahead and file the plan. That plan was then filed and became public information on March 30, 1940.

Q. Well now, how did you determine how long this disability to purchase that you felt you were under should continue? A. Until the information I had became public.

Q. I see. I have nothing more to ask Mr. Culin at this time.

Re-direct examination

By Mr. Hubbard:

Q. Mr. Culin, taking these conversations you just testified about to Mr. Baldy, will you state for the record what information you had at that time from the staff of the Commission? A. The information which I had from the staff of the Commission was that the matter had been discussed in the Commission and that they thought the plan was sufficiently meritorious to go ahead and file it. There was a short period in there when I knew something that wasn't public information. When the plan was filed it became public information.

Mr. Baldy: I think it would be worth while to be specific if you can, about dates, that on such and such a
2854 date you felt it would not be proper to purchase, et cetera.

The Witness: I did.

By Mr. Hubbard:

Q. And you have selected from these dates which you have a record of, the particular dates which you testified about in answer to Mr. Baldy's question? A. That is right.

Q. And this policy which you testified about is applicable

to the purchases by other officers and directors of the system? A. I think it is pretty generally true of the other officers and directors of the system.

Mr. Baldy: Wait a minute—all right, I will let it stand. Do you, in fact, know whether that policy was followed by the other officers and directors?

The Witness: I know it was followed by the other officers and directors prior to 1937. There was some purchasing of preferred stock at that time, more with the idea of preventing the market from just going to pieces at that time than anything else, insofar as those few purchases could help.

By Mr. Hubbard:

Q. And those purchases were criticized, were they, by a stockholder? A. In December of 1937, yes. It was after that that we talked about it and felt that we should
2855 not make any purchases which might be criticized.

I think there were very few exceptions—I think that with very few exceptions that policy was adhered to.

Mr. Baldy: You think so?

The Witness: I have studied the record and there were very few purchases that were made at any time except when full information was in the hands of the public and any purchases which might have been made, so far as I can determine, were of very small quantities and would be for some reason which doesn't appear in the information which I have.

(Witness Culin excused.)

Mr. Baldy: Will you take the stand, Mr. Chenery?

Whereupon, **Christopher Chenery**, resumed the stand and testified further as follows:

Recross-Examination

By Mr. Baldy:

Q. Mr. Chenery, have you heard Mr. Culin's testimony? A. Yes.

Q. You heard the portion of it relating to his feeling disqualified or feeling that it might be improper to make purchases of Federal stock at certain periods of time? A. Yes, sir.

Q. Did you have any policy corresponding to his in that regard? A. I had nothing to do with it at the time
2856 we were purchasing Chenery Corporation stock other than to agree in advance that a certain long-range policy would be pursued; in other words, that we would sell "X" shares of Alabama Water Service Corporation when we could buy three shares of Federal with the proceeds of the sale of one Alabama.

We gave general instruction to liquidate 700,000 or 800,000 shares of one and buy the other as those ratios of market prices came on the market. That was true, I think, with all of the substantial purchases of Chenery Corporation. The orders were given to brokers to buy when those ratios obtained.

I had no knowledge of when that was bought or sold after the decision was made to liquidate one security and buy this preferred.

Q. Now, with regard to the placing of instructions with the brokers, was there any period of time in which you felt that it would have been proper to give instructions to brokers or cancel instructions previously given? A. I think that you would not give instructions at any time unless you had special information, but my feeling has been that if there is one corporation that has ever operated in the full blare of publicity, that this one is it. It was one of the first corporations to start and give full and complete details of every transaction.

2857 Standard Statistics has given reports at three-months intervals. There have been a dozen brokerage houses which have circularized preferred stockholders consistently, telling them of every development and plan and advising them what to do.

Our own policy has been not to refuse any stockholder

any information at any time. There is no record since we have been in control of the company since March 14, 1932, of our having refused any stockholder any information on any subject.

Q. Well, can you identify for the record in a manner similar to that Mr. Culin did, periods of time in which you think it would not have been proper for you to give instructions to brokers? A. I hadn't thought of it in that light because at the time it was not in connection with any plan but over a long-term period and the plan would have little to do with it.

Q. Have you any record of the instructions which you gave brokers? A. I could identify it only by the time at which they started to liquidate substantial blocks of stocks.

Q. The record as to purchases, as I understand it, is already in? A. That is true.

Q. I don't think that the record of your instructions to brokers is in. A. I don't think that we have written
2838 instructions to brokers. I think we would have told them to sell "X" shares of Alabama as you can buy three for one in Federal preferred.

Q. You think they would have been oral? A. Pardon?

Q. You think they would have been oral? A. I think they would have been oral. We may have had some written orders to sell but after the decision was made I did not follow it.

Q. Was there any publicity given to the instructions that you gave brokers? A. No.

Mr. Baldy: That is all.

Redirect Examination

By Mr. Hubbard:

Q. Do you recall what those instructions were? A. To brokers?

Q. Yes, with respect to the sale of securities and the purchase of securities, other than you have testified to. A. I don't remember any other circumstance.

Q. At any time did you feel that you had any confidential information which was not available? A. I have never felt that after the first debacle, let us say, when I have testified on the stand, I never considered a plan imminent and I don't now consider one imminent.

Mr. Baldy: I don't quite get this last testimony in
2859 conjunction with what you previously said. Am I to understand now that you have never felt that you had any special knowledge that would make it improper for you to buy and sell stock?

The Witness: I never felt that the plan was imminent.

The Examiner: And therefore did it have any effect on your purchases or sales? That is your question. The question is whether you had any such expectation of a plan going through as to affect your own buying and selling of the stock?

Mr. Hubbard: You have never sold any?

The Witness: I have never sold any preferred stock.

The Examiner: Well, all right, buying.

The Witness: I don't think in any discussions which we have had with brokers the question has come up.

The Examiner: Has it affected your buying?

The Witness: It hasn't affected my buying because so far as I know, I have never had anything to do with the timing of the buying. The buying would take place over a long period of time. The broker would liquidate a block over a period of months and buy over a period of months.

The Examiner: All right.

The Witness: I expect though, if you would examine the record of our purchases, you would find that there were very few made at any controversial times.

Mr. Baldy: Has this practice of yours about leaving general instructions with brokers been a long con-
2860 tinued practice on your part?

The Witness: Over a period of several years.

. . . . . .

2877 Q. Now, Mr. Ingalls, did you have anything to do with the sale to the Chenery Corporation of 2700 shares of preferred stock in June, 1940, for $100,000 debentures? A. Yes, sir.

Q. Just describe what you did and the circumstances of that transaction so far as you know them. A. The idea of an exchange of those securities had been spoken
2878 over the telephone between Mr. Erskine and myself I imagine about a month previous, at which time we were not interested in making any exchange, but not only market price but events abroad led us to believe that it might be an advantageous thing for us to make an exchange, and particularly in view of the fact that another firm, Gilbert J. Postley & Company, were anxious to make a similar exchange if we would go along with them.

The first offer I believe had been for 2800 shares of stock of the Federal Water Service 5½'s; and about June 1 or 2, throwing the thing over again, we made a counter-offer to Mr. Erskine in which we offered 2500 shares of the various preferred, 6, 6½, and 7, in exchange for a hundred debentures, but the majority of it would have been 6½ and 7% preferred stock.

This was not of interest to them, and nothing further happened until the 10th day of June, at which time we talked again with Mr. Erskine, and, as you recollect, that is the day that Italy declared war against France and England, and Mr. Erskine told me, he said, "Well, I would much prefer to have you talk directly to Mr. Chenery and not have me as the go-between on this." You two fellows might just as well talk the thing over, and probably could come to a basis of trade quicker than if it was done through myself as a third party."

So that afternoon about 3:30 I went over to Mr.
2879 Chenery's office and talked the whole thing over, as to how far the plan was before the SEC and as to what the effect would be if France capitulated, and all the

various other factors that you can think of regarding that trade and the possible future market value.

We finally came to a basis of making it 2700 shares of an average of 6½% preferred stock for a hundred of the bonds. Knowing full well—and after having answered many questions regarding the company and the prospects of the SEC's approval, which looked as though it might be handed down just almost any day, I felt in view of the serious state abroad I would much prefer to have the bonds at that time than the preferred, even though I might lose somewhat in market value if the plan was approved immediately by the SEC in the next two or three days, or if, for instance, France and England were able to make a victorious battle between Germany and Italy. And today I am very much delighted we made the trade. It was a toss-up as to which it was going to benefit the most. So far I believe—I know as far as we are concerned it's been a most satisfactory trade.

Q. Now do you recall a transaction in which Green, Ellis & Anderson were interested at one time? A. Yes. As I recollect, it was some time just after war had been declared in September—it may have been 30 or 45 days after
2880 that—that Mr. Erskine called me up and said that Mr. Nosworthy of Green, Ellis & Anderson had asked him if he could make a bid on a little block of Federal preferred that was held by one of their correspondents abroad, and we called up—

Mr. Hubbard: (Interposing) May I have the name stricken out? Mr. Erskine suggests the possibility that people there in New York might not want to have their names used, so I suggest instead of—could we substitute "a brokerage firm" for "Green, Ellis & Anderson"?

Mr. Baldy: No, I think we ought to have the names. If it is going to be talked about at all, we ought to know who it is they are talking about.

Mr. Hubbard: All right.

A. (Continuing) We—or I called up Mr. Nosworthy and

told him that Mr. Erskine had mentioned that they were interested in a bid for a block of the stock and that we would be very glad to make a bid for it. Subsequently, I think it turned out to be, instead of 700 shares turned out to be nearly 1500 shares of stock that we purchased from them and then we distributed.

Q. Did they tell you where the stock was owned? A. Just it was held abroad.

Q. And you made the transaction under those circumstances? A. That is right.

2881 Q. Now, Mr. Ingalls, one of the questions that has been raised in this case is with respect to purchases by officers and directors of the company of the company stock. Have you any views with respect to that question? A. Well, I am a great believer in officers and directors owning stock in their own companies. I, frankly, always am impressed in my own mind when I see a company whose officers hold very little, if any, of the stock of their companies; and those who have enough confidence in their company to purchase their securities and hold them and retain them I believe are instilling confidence not only with brokers but also with investors.

Q. Did you know during the past three or four years that the officers and directors of Federal Water Service Corporation were purchasing preferred stock of Federal Water Service Corporation? A. Yes, sir.

Q. Did you see any impropriety in that? A. No, sir.

* * * * * * * * * *

Testimony of Christopher T. Chenery, July 23, 1940.

2893 Re-direct examination.

By Mr. Hubbard:

Q. Mr. Chenery, at the close of the last hearing you were being questioned with respect to the purchases by the Chenery Corporation. A. Yes.

Q. And these purchases are shown upon Applicant's Exhibit No. 33? A. Yes.

Q. Now I would like to take up these purchases with you and ask you as to the status of the plan at the time that these purchases were made.

Will you turn to Exhibit 33? Now according to this sheet, Chenery Corporation purchased 100 shares of stock on April 29, 1938. What was the status of the plan
2894 at that time? A. The first plan had been filed with the Commission, public hearings had been held; a complete disclosure of the position of the company, its earning position, its assets, its forecast of earnings, and everything in connection with it was on file with the SEC. There had been newspaper publicity, releases by the Commission, and complete information available to anybody who wanted it.

Q. And on April 8, 1938, you had a conference down here in Washington and had been told that the SEC would not recommend the plan? A. That is true.

Q. Now you purchased 50 shares of preferred stock—Chenery Corporation purchased 50 shares of Federal Water Service preferred stock, on May 3, 1938? A. Yes.

Q. Was the status of the plan the same? A. It was.

Q. May 6, 1938, 50 shares. Was the status of the plan the same? A. Yes.

Q. Now on August 18 you purchased—the Chenery Corporation purchased 30 shares of Federal Water Service Corporation preferred stock. What was the status of the plan at that time? A. The capital reduction plan
2895 had been filed, but we had been told that it was the opinion of the staff that the prospects of its favorable reception were remote.

Q. A hearing had been held, had it not, on the capital reduction plan? A. Yes.

Q. As an alternative plan to the one filed on November 8, 1837? A. That is true.

Q. Now was the status of the two plans the same on August 19, 1938, when the Chenery Corporation purchased 20 shares? A. Yes.

Q. August 20, 1938, when the corporation purchased 13 shares? A. Yes.

Q. August 29, 1938, when the corporation purchased 9 shares? A. Yes.

Q. And September 1, 1938, the corporation purchased 188 shares. A. Yes. No change.

Q. The status of the plan was unchanged? A. No change.

Q. And on September 12, 1938, when the corpora-
2896 tion purchased 100 shares? A. No change.

Q. And through the rest of September, 1938, there was no change? A. No change.

Q. Now on November 15, 1938, the corporation purchased 100 shares? A. Yes.

Q. What was the situation in November, 1938? I call your attention to the fact that the letter from Mr. Riter is dated November 28, 1938. A. Yes. There was no change in the situation.

Q. November 16, 1938? A. No change.

Q. November 18, 1938? A. No change.

Q. November 21, 1938? A. No change.

Q. December 2, 1938? A. We had had a conference with the staff, in a preliminary fashion, but quite inconclusive.

Q. The conference, I call your attention, did not take place until December 5. A. December 5?

Q. 1938. The conference had been arranged at
2897 that time. A. No change on that date.

Q. December 6, 1938, the corporation purchased 25 shares. That was the day after the conference in Washington, at which you were handed the memorandum by Mr. Fortas. A. Yes, and we were quite far apart.

Mr. Baldy: There were 35 shares purchased on that day.

Q. And then there was another 10 shares purchased on December 6, 1938, making 35 shares on December 6, 1938? A. Yes.

Q. Now on March 20, 1939, the corporation, the Chenery Corporation, purchased 600 shares. A. That is true.

Q. Now prior to that purchase had any publicity been given out with respect to the filing of a new plan? A. The

Wall Street Journal on February 15 had published a full and complete outline of the plan which was to be proposed.

Q. I show you a clipping from the Wall Street Journal as of February 15, 1939, and ask you if that is the statement to which you refer. A. That is the statement to which I refer.

Mr. Hubbard: I offer it in evidence.

(The Examiner: Admitted.)

(The document referred to was received in evidence as Applicant's Exhibit No. 38.)

2898 Q. At that time had any agreement been reached with the staff or with the Commission as to the approval of that plan which was referred to in the Wall Street Journal? A. No.

Q. Now on May 2, 1939, Chenery Corporation purchased 84 shares. A. Yes.

Q. What was the status of the plan at that time? A. Mr. Culin—I find I asked him to give me the dates of the conferences which he considered vital and which he testified might have an effect, and he thought that between the period April 28 and May 11 that the officers might have had special information which wasn't generally public. Now I would like to say in that that I don't think that the officers ever had information which wasn't generally available to stockholders. In fact, one of the dissenting stockholders, Mr. Russo, has always had much better information than I have and he could tell us in advance what the situation would be, much more clearly and much more accurately than were our own views of it. Where he got it or how he got it, I have no knowledge. All I know is that he could and would and did on several occasions forecast correctly the action of the Commission, saying he could get information to that point.

Q. Now I call your attention to the fact that there was a conference here in Washington on April 26, 1939. I

2899 show you what purports to be a memorandum of that conference and ask you what the situation was with respect to the plan and the attitude of the Commission at that time.

The Witness: Will you read the question?

(The question was read by the reporter.)

Q. Do you recall having a conference with Judge Healy? A. I do.

Q. Do you recall whether or not it was suggested to Judge Healy as a possible procedure that the Commission turn down both plans, if that was the view of the Commission, and in its order state what plan would be satisfactory to the Commission? A. Yes.

Q. And judge Healy thought that—or expressed himself, did he not, as thinking that that was worthy of consideration? A. Yes.

Q. Now was any tentative procedure with respect to plans discussed with the Commission at that conference on April 26, 1939? A. The procedure was discussed that the Commission could, in a report, if it denied two alternative plans which were then before it becoming effective, could suggest a third alternative plan. That was——

Q. (Interposing) Did you know on April 26, 1939, that the Commission was favorably disposed to the plan
2900 which was filed in May, 1939? A. No, I certainly did not.

Q. At that conference the possibility of purchasing preferred stock by the corporation was referred to, was it not? A. It was.

Q. And that was the conference at which Mr. Spencer expressed himself as thinking that the suggestion was terrible? A. That is true.

Q. Now two days later what happened? A. I see by this list that Chenery Corporation bought——

Q. (Interposing) I meant with respect to the plans. A. Oh, with respect to the plan. Very much to my surprise, Mr. Spencer called me on the telephone.

Q. And advised you in substance as you have testified heretofore? A. That is correct.

Q. Now have you caused an investigation to be made as to the instructions which were given with respect to the purchase of the 84 shares of preferred stock on May 2, 1939? A. I have.

Q. Will you state what those instructions were? A. On April 26, 1939, two days before this, the corporation wrote a letter to Gilbert J. Postley.

Q. By "the corporation" you mean Chenery Cor-
2901 poration? A. The Chenery Corporation—which stated: "This will authorize you to sell for our account 250 shares of Alabama Water Service $6 preferred stock, and to purchase with the funds from this sale Federal Water Service Corporation preferred stock on the basis of about four shares of Federal for one share of Alabama. Yours very truly, Chenery Corporation, Jacqueline Sanford, assistant secretary."

Q. And the 84 shares that were purchased were in pursuance of those instructions? A. Pursuance of those instructions.

Q. Now the next plan was filed on May 11, 1939, was it not? A. Yes.

Q. And on May 19, 1939, Chenery Corporation purchased 244 shares of preferred stock? A. That is right.

Q. Have you a record showing when publicity was given to that, to the filing of that plan? A. I have here Securities and Exchange Commission Holding Company Act Release No. 1536, dated May 16, 1939, covering the details of the plan.

Q. Chenery Corporation made purchases June 6, 1939, and June 29, 1939? A. That is true.

Q. And the status of the plan was that it was pend-
2902 ing before the Commission at that time. A. That is true.

Q. The Havender decision in the Chancery Court of Delaware came down in the early part of June, 1939, did it

not? A. That is my recollection. I haven't the definite date before me.

Q. I show you a memorandum of a conference held with the staff of the Securities and Exchange Commission on June 20, 1939, and ask you if that refreshes your recollection as to whether the decision in the Havender case in the Chancery Court had come down before that date. A. It had come down before June 20.

Q. I show you a memorandum of a conference in the office of the SEC on June 28, 1939, and ask you if that refreshes your recollection as to the status of plans at that time. A. It does.

Q. And what was the status at that time? A. The Havender decision had made the plan filed inapplicable, and the Commission staff was discussing with us filing under 11(e), isn't it?

Q. That was the first suggestion that you had received for reorganization of Federal Water Service Corporation under the Holding Company Act in the manner now permitted by Delaware corporation law? A. That is true. I modify that this way: that a day or two prior to
2903 this, suggestion had been made by telephone, but this was the first meeting of which I have a record at which we discussed it down here.

Q. Then on June 29, 1939, the status of the situation was that the plan before the Commission had been interfered with by the decision of the Delaware Court in the Havender case and a suggestion had been made by the staff of the SEC for reorganization under Section 11(e)? A. That is true.

Q. And state whether or not it looked as if you were about as far away from a plan as ever. A. It did. It did so look. The opinion of our counsel was that the plan under 11(e) was in conflict with Delaware law, and his advice to us was not to file such a plan.

Q. Now was that the status of the plan in July, 1939? A. That was the status——

Q. (Interposing) I am not overlooking the fact that

there were various conferences with the SEC during that period—— A. Yes.

Q. (Continuing)—but was anything conclusive reached? A. We had no thought of being able to agree with the SEC on the plan at that time. We seemed very far apart.

Q. But during that period you were attempting
2904 to work something out? A. We were attempting earnestly to work something out.

Q. Along the lines of the common stock plan? A. That is true.

Q. Either under 11(e) or some other procedure? A. That is true.

Q. And was that the situation generally in August, 1939? A. August, 1939, we reinstated the capital reduction plan, because we could not agree with the staff of the Commission on the filing under 11(e) plan, and because they insisted on our going to hearing on plans which were then pending, so their dockets could be closed.

Q. And you had a hearing on the capital reduction plan on August 29 and August 30, 1939? A. Yes. We had no reason to believe that the Commission would—

Q. (Interposing) Approve the plan? A. (Continuing) —approve the plan.

Q. But publicity had been given to the capital reduction plan through notice of hearing, had it not? A. Well, this was merely a reinstatement of the capital reduction plan which had been filed the year before, and publicity had been given at that time, about a month after the plan had been originally filed with the Commission.

Q. Now was the situation approximately the same
2905 in September, 1939? A. Yes.

Q. And November, 1939? A. Yes.

Q. And in January, 1940, on January 3, 1940? A. Up until the reversal of the Havender case in January, 1940.

Mr. Hubbard: Off the record.

(Discussion off the record.)

Q. Mr. Chenery, there appears on Exhibit 33 that Chenery Corporation made a purchase of 2700 shares of Federal Water Service preferred stock in exchange for $100,000 par value of Federal Water debentures. You have heard Mr. Ingalls' testimony this morning with respect to that transaction? A. Yes.

Q. Will you state the circumstances of that transaction? A. My recollection of it doesn't differ in any substantial particular from Mr. Ingalls'.

Ingalls & Snyder had acquired a large block of preferred stock, some in their own hands, some in the hands of their clients. Postley had a substantial block of preferred stock, some in his own hands and some in the hands of his clients. The suggestion had been made that that block might be used as a basis of control and sold to some group who might desire control and that it might be a profitable thing
2906 to the holders of that stock if they so did.

They asked what we thought about it, and I expressed the opinion that it was their own stock, they bought it and paid for it and could do as they pleased, but if they asked me whether I would consider it a friendly thing to attempt to go out and sell control of the company that I wouldn't regard it as a friendly action.

Well, they said our position was very weak and that we ought to have more stock, which I agreed. We discussed the purchase with them—or the exchange, rather, of a hundred thousand Federal debentures for this stock.

I thought the market was pretty jittery and would get more so and that they wouldn't want to hold very large blocks of stock for which there was no market, wouldn't want to be tied up with it, especially with Italy heading for war, and that it was to the advantage of our group to buy this stock, buy it not for quick profits, because that was never inherent in the purchase at any time—no one who wanted quick profits would tie up large sums of money in Federal Water Service preferred stock, especially if he was

an officer and director and would be prohibited from getting out in a six-months' period. The purchase obviously had to be to strengthen the position.

I think on one jittery day I suggested to Mr. Erskine that he tell them to exchange the debentures for 3000
2807 shares, and they thought that they would exchange for 2500 shares, and conversations jockeyed back and forth. Each time the market would go up a little bit, they would go down a few shares and each time it would go down we would want more. And then finally the day Italy declared war nobody knew what was going to happen; we came to an agreement on 2700 shares of 6½ equivalent preferred stock for the hundred thousand debentures.

Q. Now, Mr. Chenery, after these tentative findings and conclusions of law came down, request was made in behalf of the SEC, was it not, for opportunity to examine the broker's confirmation slips and all other memoranda with respect to the purchases by Chenery Corporation? A. It was.

Q. And representatives of the SEC came to New York to make the investigation? A. They did.

Q. Did you give them every facility? A. I think they will so testify.

Q. And you so testify? A. And I so testify.

Q. Just so the answer is complete: you gave them every facility to make any investigation they wanted to with respect to those purchases? A. I gave them—I did.

2808 Q. And how long were they in New York? A. I don't know. I saw them on two separate days. Whether they were there longer than that, I don't know.

Q. How many men? A. Three, I think.

Q. Now, Mr. Chenery, do you recall back in October, 1937, purchases of preferred stock at a market break? A. Very clearly.

Q. Did you consider there was any impropriety in making those purchases? A. I thought that we were rendering a real service to stockholders.

Q. In making the purchases? A. In making the purchases. The market dropped away. There were no bids. People had to sell the stock. Anybody who came in the market during that period with a bid for stock was rendering a service to the stockholder in that he was making a market which didn't then exist.

Q. Now after those purchases there was a hearing in Washington with respect to the plan filed on November 8, 1937? A. That is true.

Q. And the Class A stockholders were represented at that hearing by Mr. Levin? A. That is true.

Q. And Mr. Levin questioned you about those pur-
2909 chases? A. That is true.

Q. And undertook to criticize the purchases, is that correct. A. That is true.

Q. What did you think about that criticism? A. I thought it was unjust and unfair, and it rankled a great deal, and a plan had been filed, but it seemed to me that it was hitting a minor thing and giving it major importance. Plans are filed and are withdrawn, or something happens or doesn't happen, but the world goes on, wars are declared, markets break, earnings go up or earnings go down, and those are the things which affect your values, not the imminence of a plan.

I thought that this imminence—I knew a plan was to be filed in October, but I thought the filing of a plan in October, with a market break and values crashing all around, had nothing to do with the price of the stock, the price of the stock was reflecting the general break in the market, and that by purchasing at that time we were rendering a service to stockholders, and we were also buying stock at a level which I considered cheap, but we were criticized.

Now I read this testimony again last night and it refreshed my recollection a good deal. I remember—

Q. (Interrupting) You mean you considered the testimony; you didn't read it, did you? A. I read the
2910 testimony last night.

Q. The testimony of the original hearing? A. 1937

h ng, yes. And it refreshed my recollection a good deal.

I think when that hearing was over and after that criticism had been made, which we considered unjust, we had a meeting in our offices, attended by our executives, and at that time we agreed that from then on we would not purchase stock or let stock be purchased at any time at which we could be criticized, even unfairly. That criticism had rankled enough so that we did not want to be in that position again.

The Examiner: Off the record.

(Discussion off the record.)

Q. What was the conference which you had at that office? A. The conference was one of the executives of the corporation. I can't place the date of it; I was vague about it yesterday. Reading this testimony refreshed my recollection last night, and the effect of the conference was an understanding among all officers that no stock would be purchased at any time at which it could be said, fairly or unfairly, that we had more information than the general public.

Q. I think you testified yesterday that the details of these purchases were not handled by you. A. They were
2911 not handled by me, and I had no knowledge of the timing of the purchases.

Mr. Hubbard: I have no further questions.

Re-Cross Examination

By Mr. Baldy:

Q. Mr. Chenery, that conference to which you refer, at which you determined a policy to avoid purchases which might be criticized, what were the criteria that you determined upon by which you would judge whether a purchase was open to criticism or not? A. Whether we had information not generally available which would or could substantially affect the market price of the stock.

Q. What do you mean by "generally available"? You

mean if somebody came down, if it was a matter of public record in the files of the SEC, then you were free to purchase? A. If it was a matter of public record in the files of the SEC and if there had been public announcement.

Q. And if there had been a public announcement? A. If there had been a public announcement, yes.

Q. Then you felt that it was entirely proper under those circumstances for you to avail yourself of information which had been given that degree of publicity? A. Yes, because that same information was available to anybody else who wanted it.

* * * * * * * * * *

Testimony of Howard M Erskine, July 23, 1940.

2916 Q. Mr. Erskine, you are an officer of Federal Water Service Corporation? A. I am.

2917 Q. What position do you hold? A. My particular duties are that relating to securities of the corporation itself, under the various subsidiary companies, the financing of all of the subsidiary companies, and in general the bonds and stocks of all subsidiary companies—that is, anything to do with refunding and refinancing is all in my department.

Q. You are vice-president of the company, are you not? A. Yes, sir.

Q. And when did you become vice-president of Federal Water Service Corporation? A. I think in the spring of 1939.

Q. You are a director of Federal Water Service Corporation? A. I am now—pardon me: you said officer or director?

Q. I said vice-president. A. I became vice-president January 1, 1937. I am sorry.

Q. When did you become a director? A. I think in the spring of 1939.

Q. Now, Mr. Erskine, as part of your duties do you keep in touch with market conditions of Federal Water Service Corporation preferred stock and stocks of the subsidiaries, bonds of the corporation, and bonds of the subsidiaries? A. Yes, sir.

Q. Will you state the number of dealers, in your
2918 judgment, who are interested in Federal Water Service Corporation stock? A. Well, I can only answer that very generally. I would say that from three or four or five in an inactive market to probably fifty in an active market. It would fluctuate, the number of dealers interested in the trading of those stocks would fluctuate with the activity in the market.

Q. What do these dealers do in connection with purchases and sales of Federal Water Service Corporation preferred stock? A. Well, the Federal Water being an unlisted security, it is included in a list called the National Quotation Sheets, which list all of the securities of corporations where they are not listed on the New York Stock Exchange or on the New York Curb, and those are distributed very widely, I understand, throughout the whole country.

In addition to that, the National Association of Security Dealers I believe give to the various newspapers throughout the country quotations on over-the-counter securities, and among those Federal Water Service preferred stocks are invariably quoted.

Q. During the period from November 8, 1937, down to date, in your judgment was there plenty of preferred stock available to anyone who wanted to buy it? A. Yes, sir.

2919 Q. At the present time about how long do you think it would take to acquire 10,000 shares of Federal Water Service Corporation preferred stock at about the market price? A. It is a very difficult guess. I would guess from three to six months, but that would be governed by market conditions and many, many things.

Q. Now you from time to time were requested by the

Chenery Corporation and other officers of Federal Water Service Corporation and its subsidiary companies to take some action with respect to purchases of preferred stock, were you not? A. That is true.

Q. And what did you do? A. Invariably, Mr. Hubbard—a typical example would be an officer or employee coming to me and asking what the market is on the stock. I would telephone or get for him the market on the stock, and he would indicate his desire to buy 10 shares or 50 shares or whatever it happened to be, and I would say, "That stock can be obtained from such-and-such a broker", and contacted the broker and the individual who wanted to buy the stock, and thereafter—

Q. (Interposing) Thereafter the negotiations were between the broker— A. (Interposing) Thereafter the confirmation, and so forth, would be between the broker and the individual.

2920 Q. How much time do you suppose this service, if we may call it such, took you in the course of a day? A. Oh, probably a couple of telephone calls, Mr. Hubbard—a very few minutes. I didn't devote any time to it particularly.

Q Now you have heard Mr. Ingalls testify with respect to his almost daily calls to you. What was the nature of those telephone calls? A. Mainly to give me various quotations. I have an early morning, as soon as the market opens, several brokers who call me, probably four or five, who will call me on quotations on various securities as applied to the Federal Water Service System. We are always interested in where our bonds of subsidiary companies, our Federal bonds, our stocks of subsidiary companies are selling; and I receive those quotations, jot it on a piece of paper on my desk.

That is the prime motive for the conversations. There might be a few seconds of general conversation—sometimes, in the case of Mr. Ingalls, a few questions whether there

is anything new in the situation, the Federal situation, and we have general conversation—

Q. Is the contact which you have with Mr. Ingalls in this regard any different from that with a number of other brokers? A. Oh, no. No, no.

2921 Q. How many houses do you suppose you have such connections with? Is it practically all of those who are actively engaged in making a market for Federal Water Service Corporation preferred stock. A. Yes, sir. The calls from dealers will probably fluctuate with the market activity, or with any publicity that is given earnings of the various subsidiary companies, or publicity as to the plan, if you will.

Q. Is it general practice in New York City for banks and brokerage houses and investment companies to call you up and ask you questions about the company? A. Yes; not only New York City, but out of town, also.

Q. Can you give us a typical example of the way that thing works? A. Well, a typical example would be that a firm in Portland, Maine, will call and say, "I have an inquiry from a customer who owns some—or wants to buy some New York Water preferred stock. Is there anything new in that situation, or anything that I can tell him?"

I say—well, if there is, I will probably tell him; if there isn't, I probably won't, if there is nothing new in the situation. If earnings have been published and if he hasn't the latest earnings, I will send them to him.

Q. Have you ever suppressed any information from any stockholder or investment house or broker or any-

2922 body who asked you for information? A. Certainly not, knowingly.

Q. You endeavor to give him as accurate a picture of the situation as you know? A. I usually tell him what I know, Mr. Hubbard, entering no opinion one way or the other on the purchase or sale of securities.

Q. Well, do you always do it?

The Witness: Will you read my last answer?

(The answer was read by the reporter.)

A. Always tell him—I correct that to "always".

Q. You don't know of any time when you had information and you were asked about it that you didn't give it, do you? A. No, sir.

Q. It is a policy of the company, and has been since you have been connected with it— A. (Interposing) Yes, sir.

Q. (Continuing) —to give absolutely all information which the officers and directors have to an inquiring person? A. That is correct.

Q. Now, Mr. Erskine, do you recall a conversation as to the officers and directors purchasing preferred stock at times when they might have information which was not known to other people with respect to plans or other circumstances? A. Yes, sir.

2923 Q. What was said at that conference? A. The first conference was held, as has been testified, after the hearing of 1937, in which the purchases by officers was criticized, and we simply decided that we would not be subject to criticism and that we would not purchase securities when the public did not have full—the same information that we had regarding the plan or any other situation.

Q. And there was another conference, was there, at some subsequent time? A. Yes, sir. I have a memorandum of another conference held in January, 1939, which memorandum shows that such conference was held with Mr. Chenery, Mr. Culin, and Mr. McHenry and myself, regarding the purchase of preferred stock at that particular time, and it was decided at that time that we should continue to follow our policy of not purchasing stock so long as the public did not have the same information that we did; and at that particular conference there was a—the proposition under discussion was released, I find, on February 15, in the Wall Street Journal; that was the green light, was February 15, after the publicity was in the Wall Street Journal.

Q. According to Exhibit No. 33, Mr. Erskine, you pur-

chased 50 shares of Federal Water Service Corporation preferred stock on September 7, 1938, and 25 shares
2924 on September 27, 1938. A. That is correct.

Q. Do you know of any impropriety in connection with that purchase? A. I felt no such impropriety, no, sir.

Q. Why did you make the purchase? A. Briefly, I thought the stock was cheap, and I was interested in being a member of the group who owned the stock in order that we should all have a continuing voice in the management of the business.

Q. Have you made a comparison between the prices of Federal Water Service Corporation preferred stock as quoted in the market and the Dow-Jones averages? A. I did.

Q. What did that comparison show. A. Comparison shows me that the price of the Federal preferred stock followed very closely the Dow-Jones averages up until December, January—December, 1939—January, 1940.

The Examiner: Off the record.

(Discussion off the record.)

The Witness: They are called Dow-Jones averages. Whether they are only industrial averages or not, I don't know. They are contained in a chart published by the Institute of Applied Econometrics, of New York City. And also in this chart, I might add, there is another line
2925 entitled "Major Business Trend", which is a scientific curve of the trend of business as it is and as it has been over a period of years, and in December, 1939—January, 1940, it appears that the price of the Federal stock went against the market. It went up and the market stayed steady until May, but during that period all utility stocks and bonds were very strong—it was a utility market, in other words, when all utilities went against the market, so that Federal Water Service in that instance followed closely all utilities.

Q. What conclusion do you draw from that comparison?

A. I conclude that, first, that the purchase of preferred stock by the officers, directors, and employees of the corporation had no effect whatever upon the market. It leads me to the conclusion that there was a slight flurry in the market—saw-toothed, in other words, in the chart.

. . . . . .

2950 Mr. Hubbard: It is hereby stipulated between counsel for the applicant and counsel for the Commission that there be incorporated in the record the Commission's File No. 39-1-1, being reports filed with the Securities and Exchange Commission on form U17-1 and U17-2, by officers and directors, Federal Water Service Corporation and Utility Operators Company.

It is not, however, necessary to copy this file into the transcript of the record.

APPLICANT'S EXHIBIT NO. 33 (DOCKET NO. 81).

PREFERRED STOCK OF FEDERAL WATER SERVICE CORPORATION PURCHASED BY OFFICERS AND DIRECTORS OF FEDERAL AND UTILITY OPERATORS COMPANY FROM NOVEMBER 8, 1937 TO JUNE 30, 1940

	Div. Rate Pfd.	Date of Purchase	Number of Shares		Price per Share	Total Cost
J. H. Greene	$6.00	2/1/39	45		$21.25	$ 956.25
W. R. Edwards	6.00	10/4/38	100		19.25	1,925.00
G. H. Chesney	6.50	9/13/38	25		19.75	493.75
	6.50	9/26/38	25		19.00	475.00
	6.50	10/3/38	25		18.50	462.50
	6.00	10/4/38	25		18.75	468.75
	6.50	11/9/38	25		23.50	587.50
	6.00	11/18/38	25		21.25	531.25
	6.00	11/23/38	10		19.50	195.00
	6.00	11/29/38	20		19.50	390.00
	6.50	12/5/38	25		19.50	487.50
	6.50	5/3/39	25		25.25	631.25
	6.00	1/9/40	70		34.00	2,380.00
			300	Av.	23.675	7,102.50
H. G. Calder	6.50	9/12/38	40		21.50	860.00
C. G. Herren	6.50	9/12/38	10		21.50	215.00
C. P. Rather	6.50	9/7/38	200		21.50	4,300.00
	6.50	11/16/38	100		21.50	2,150.00
	6.00	1/25/40	100		34.00	3,400.00
	6.50	5/14/40	10		36.50	365.00
	6.00	5/14/40	10		35.50	355.00
			420	Av.	25.167	10,570.00
R. H. Hollson	6.00	10/26/38	10		22.25	222.50
Wm. E. Matthews, III	6.50	9/8/38	65		21.50	1,397.50
H. T. Ellwood	6.50	9/30/38	38		18.50	703.00
	6.50	10/3/38	12		19.75	237.00
	6.00	1/3/40	30		34.00	1,020.00
			80	Av.	24.50	1,960.00

C. P. Rather	6.50	9/7/38	200		21.50	4,300.00
	6.50	11/16/38	100		21.50	2,150.00
	6.00	1/25/40	100		34.00	3,400.00
	6.50	5/14/40	10		36.50	365.00
	6.00	5/14/40	10		35.50	355.00
			420	Av.	25.167	10,570.00
R. E. Sellers	6.00	10/26/38	10		22.25	222.50
Wm. E. Matthews, III	6.50	9/8/38	65		21.50	1,397.50
E. T. Ellwood	6.50	9/30/38	38		18.50	703.00
	6.50	10/3/38	12		19.75	237.00
	6.00	1/3/40	30		34.00	1,020.00
			80	Av.	24.50	1,960.00
Watson Burt	6.50	9/1/38	5		21.50	107.50
	6.00	10/24/38	5		22.25	111.25
	6.50	11/21/38	5		20.50	102.50
	6.50	4/14/39	15		21.75	326.25
	6.50	4/14/39	10		21.25	212.50
	6.50	4/24/39	25		21.50	537.50
	6.50	5/2/39	25		23.25	581.25
	6.50	5/2/39	25		23.50	587.50
	6.50	9/19/39	50		21.50	1,075.00
	7.00	10/3/39	60		27.00	1,620.00
			225	Av.	23.38-1/3	5,261.25
E. C. Beal	6.00	10/4/38	10		19.25	192.50
	6.00	11/23/38	25		20.00	500.00
	6.00	2/6/40	50		35.25	1,762.50
			85	Av.	28.888	2,455.00

Mr. G. H. Chemery also has a beneficial interest in the securities owned by Chemery Corporation.

	Div. Rate Pfd.	Date of Purchase	Number of Shares		Price per Share	Total Cost
E. Z. Erskine	$6.50	9/7/38	50		$21.50	$ 1,075.00
	6.00	9/27/38	25		16.50	412.50
			75	Av.	19.833	1,487.50
F. T. Tunstill	6.50	9/2/38	50		21.50	1,075.00
	6.50	11/28/39	15		26.00	390.00
			65	Av.	22.538	1,465.00
Loren Fitch	6.00	11/23/38	1		20.00	20.00
F. R. Harris	6.00	1/31/39	40		22.25	890.00
	6.00	2/1/39	90		22.75	2,047.50
	6.50	1/31/39	18		23.25	418.50
	6.50	2/1/39	155		23.75	3,681.25
	7.00	1/31/39	25		24.75	618.75
	7.00	2/1/39	15		25.25	378.75
			343	Av.	23.425	8,034.75
H. A. Gulin	6.50	9/3/38	50		21.50	1,075.00
	6.50	11/9/38	10		23.50	235.00
	6.50	11/28/39	50		26.00	1,300.00
	6.00	1/4/40	50		33.00	1,650.00
			160	Av.	26.625	4,260.00
H. D. McHenry	6.50	9/7/38	50		21.50	1,075.00
	6.50	11/4/39	25		25.00	625.00
	7.00	1/10/40	15		36.50	547.50
			90	Av.	24.972	2,247.50

W. A. Gulin	6.50	9/3/38	50		21.50	1,075.00
	6.50	11/9/38	10		23.50	235.00
	6.50	11/28/39	50		26.00	1,300.00
	6.00	1/4/40	50		33.00	1,650.00
			160	Av.	26.625	4,260.00
H. D. McHenry	6.50	9/7/38	50		21.50	1,075.00
	6.50	11/6/39	25		25.00	625.00
	7.00	1/10/40	15		36.50	547.50
			90	Av.	24.972	2,247.50
C. van den Berg, Jr.	6.50	12/13/37	209		23.87½	4,846.63
	6.50	12/15/37	45		21.25	956.25
	6.50	12/17/37	120		22.64-7/12	2,717.50
	6.50	12/28/37	20		21.50	430.00
	6.50	1/5/38	25		21.50	537.50
	6.50	3/2/38	50		23.00	1,150.00
	6.50	3/3/38	33		23.00	759.00
	6.50	3/4/38	17		23.00	391.00
	7.00	5/10/38	28		21.25	595.00
	7.00	5/12/38	87		22.75	1,979.25
	6.50	5/10/38	47		28.00	940.00
	6.50	7/20/38	20		20.25	405.00
	6.50	7/25/38	40		20.25	810.00
	6.50	10/25/38	100		22.75	2,275.00
	6.50	10/28/38	250		22.90	5,725.00
	6.50	10/31/38	3		20.75	62.25
	7.00	11/3/38	25		25.25	631.25
	6.50	11/3/38	100		24.00	2,400.00
	6.50	11/9/38	100		23.50	2,350.00
	6.50	11/21/38	75		20.25	1,518.75
	6.50	11/30/38	50		19.75	987.50
	6.50	12/1/38	43		19.69-2/3	847.00
	6.50	12/3/38	94		19.6303	1,845.25
	6.50	11/28/39	100		26.00	2,600.00
			1,675	Av.	22.543	37,759.13

	Div. Rate Pfd.	Date of Purchase	Number of Shares	Price per Share	Total Cost
Owned by Chenery Corporation, a corporation wholly owned by C. T. Chenery and members of his family (including Mr. C. M. Chenery)	$6.00	4/29/38	30	$16.50	$ 495.00
	7.00	4/29/38	30	19.00	570.00
	7.00	4/29/38	40	18.50	740.00
	7.00	5/3/38	25	18.00	450.00
	7.00	5/3/38	25	18.00	450.00
	6.00	5/6/38	50	18.50	925.00
	6.50	8/18/38	20	20.75	415.00
	6.50	8/18/38	10	20.75	207.50
	6.50	8/19/38	20	20.75	415.00
	6.50	8/20/38	13	20.75	269.75
	6.50	8/29/38	9	20.50	184.50
	6.00	9/1/38	188	20.00	3,760.00
	6.50	9/12/38	100	21.125	2,112.50
	6.50	9/15/38	50	20.50	1,025.00
	6.50	9/15/38	70	19.25	1,347.50
	6.50	9/23/38	170	19.00	3,230.00
	6.50	9/28/38	25	18.50	462.50
	6.50	9/30/38	35	19.00	665.00
	6.00	11/15/38	100	21.125	2,112.50
	6.50	11/16/38	100	21.00	2,100.00
	6.00	11/18/38	100	20.50	2,050.00
	6.00	11/21/38	75	20.50	1,537.50
	6.00	12/2/38	50	19.00	950.00
	6.50	12/6/38	25	21.75	543.75
	6.50	12/6/38	10	22.75	227.50
	6.50	3/20/39	450	23.00	10,350.00
	7.00	3/20/39	150	23.00	3,450.00
	6.50	5/2/39	84	21.1607	1,777.50
	6.50	5/19/39	244	24.3196	5,933.98
	6.50	6/6/39	84	23.988	2,015.00
	6.50	6/29/39	12	20.665	247.98
	6.50	6/29/39	120	20.665	2,479.80
	6.00	7/5/39	115	21.5174	2,474.50
	6.00	7/6/39	25	22.00	550.00
	6.50	7/6/39	25	22.25	556.25
	6.50	7/6/39	30	23.25	697.50
	6.00	7/21/39	40	24.75	990.00
	6.00	7/21/39	50	24.75	1,237.50
	6.00	7/24/39	20	24.75	495.00
	6.00	7/25/39	100	24.75	2,475.00
	6.00	7/25/39	67	25.00	1,675.00
	6.00	7/25/39	50	24.75	1,237.50
	6.50	7/25/39	75	25.25	1,893.75
	6.50	7/26/39	12	25.25	303.00
	6.00	7/26/39	33	24.50	808.50

6.00	12/2/38	50	19.00	950.00
6.50	12/6/38	25	21.75	543.75
6.50	12/6/38	10	22.75	227.50
6.50	3/20/39	450	23.00	10,350.00
7.00	3/20/39	150	23.00	3,450.00
6.50	5/2/39	84	21.1607	1,777.50
6.50	5/19/39	244	24.3196	5,933.98
6.50	6/6/39	84	23.988	2,015.00
6.50	6/29/39	12	20.665	247.98
6.50	6/29/39	120	20.665	2,479.80
6.00	7/5/39	115	21.5174	2,474.50
6.00	7/6/39	25	22.00	550.00
6.50	7/6/39	25	22.25	556.25
6.50	7/6/39	30	23.25	697.50
6.00	7/21/39	40	24.75	990.00
6.00	7/21/39	50	24.75	1,237.50
6.00	7/24/39	20	24.75	495.00
6.00	7/25/39	100	24.75	2,475.00
6.00	7/25/39	67	25.00	1,675.00
6.00	7/25/39	50	24.75	1,237.50
6.50	7/25/39	75	25.25	1,893.75
6.50	7/26/39	12	25.25	303.00
6.00	7/26/39	33	24.50	808.50
6.50	7/27/39	30	25.00	750.00
6.50	7/29/39	15	24.25	363.75
6.50	7/31/39	35	24.75	866.25
6.00	8/1/39	80	24.25	1,940.00
6.00	8/1/39	20	24.00	480.00
6.00	8/1/39	25	24.50	612.50
6.00	8/2/39	50	25.00	1,250.00
6.00	8/2/39	10	24.75	247.50
6.50	8/2/39	15	25.25	378.75
6.50	8/3/39	6	26.50	159.00
6.00	8/3/39	8	25.50	204.00
6.00	8/3/39	16	25.75	412.00
6.00	8/3/39	25	26.00	650.00
6.00	8/7/39	200	25.50	5,100.00
6.00	8/11/39	175	25.50	4,462.50

	Div. Rate Pfd.	Date of Purchase	Number of Shares		Price per Share	Total Cost
Chesapeake Corp. (continued)	$6.00	8/15/39	45		$25.50	$ 1,147.50
	6.50	8/15/39	224		26.00	5,824.00
	6.50	8/16/39	109		26.00	2,834.00
	6.00	9/22/39	150		21.25	3,187.50
	6.00	9/25/39	75		21.25	1,593.75
	7.00	9/27/39	110		23.00	2,530.00
	6.00	9/28/39	26		22.25	578.50
	6.00	9/29/39	10		24.50	245.00
	6.00	10/11/39	65		25.00	1,625.00
	6.00	10/13/39	25		24.75	618.75
	6.00	10/16/39	25		24.50	612.50
	6.00	10/17/39	10		24.75	247.50
	6.00	10/19/39	10		24.75	247.50
	6.00	10/19/39	100		25.00	2,500.00
	6.00	10/21/39	50		24.75	1,237.50
	6.00	10/23/39	75		25.00	1,875.00
	6.00	10/23/39	39		25.00	975.00
	6.00	10/23/39	17		25.00	425.00
	6.50	10/23/39	22		25.25	555.50
	6.50	10/23/39	40		25.375	1,015.00
	6.00	10/24/39	12		24.75	297.00
	6.00	10/24/39	22		25.00	550.00
	6.00	10/24/39	50		24.75	1,237.50
	6.00	10/25/39	25		25.25	631.25
	6.00	10/25/39	80		25.25	2,020.00
	6.00	10/25/39	10		25.00	250.00
	6.50	10/25/39	20		25.50	510.00
	6.00	10/27/39	30		25.375	761.25
	6.00	10/31/39	18		25.00	450.00
	6.00	10/31/39	50		25.25	1,262.50
	6.00	10/31/39	50		26.00	1,300.00
	6.50	11/2/39	100		24.875	2,487.50
	7.00	11/2/39	50		25.50	1,275.00
	6.00	1/3/40	308		34.00	10,472.00
				Av.	23.6816	
	6.00	6/10/40	781	}		
	6.50	6/10/40	1,138	} -		100,000.00*
	7.00	6/10/40	781	}		
			8,618	Av.	27.866	$ 240,148.01

*All of these transactions reflected the exchange of $100,000 principal amount of 5½% Debentures for an aggregate of 2700 shares of preferred stock of the various series indicated, without payment or receipt of any cash consideration.

APPLICANT'S EXHIBIT NO. 36 (DOCKET NO. 84).

TRANSFERS OF FEDERAL PREFERRED DURING 1936 - 1940

	1936	1937	1938	1939	6 mos. 1940
$6	55,946	33,755	17,755	31,138	20,685
$6.50	54,345	36,505	18,171	27,818	15,596
$7	11,068	7,365	3,961	5,875	3,083
$4	430	350	251	189	95
Total transfers	121,789	77,975	40,138	65,020	39,459
Purchases by officers and directors of Federal and Utility Operators Company	170	1,465	3,653	5,023	3,343
Traded by Gilbert J. Postley & Co.		5,820	14,468	28,458	22,529 (to 7/18/40)

Exerpts from Findings and Opinion of Commission, March 24, 1941.

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3933 · Securities and Exchange Commission
. . Washington

In the Matter of

FEDERAL WATER SERVICE CORPORATION
UTILITY OPERATORS COMPANY
FEDERAL WATER AND GAS CORPORATION

File Nos. 34- 9
34-41
70-28

(Public Utility Holding Company Act of 1935)

Findings and Opinion of the Commission

* * * * * * * * * * *

3935 The applications and declarations[1] underlying this case have as their primary objective the reorganization of Federal Water Service Corporation
3936 (hereinafter called "Federal") pursuant to a plan of merger proposed by its management. The contemplated reorganization is to be effectuated by a merger of Utility Operators Company, the parent of Federal, and Federal Water and Gas Corporation, a wholly owned subsidiary of Federal, into Federal.[2] Utility Operators Com-

[1] Federal Water Service Corporation has filed (File No. 34-9) an application pursuant to Rule U 12E 4, for a report on a plan for its reorganization, and a declaration pursuant to Rule U-12E-5, with respect to solicitation of consents to this plan. Utility Operators Company has filed (File No. 34-41) a similar application and declaration. Federal Water Service Corporation and Utility Operators Company have jointly filed (File No. 70-28) a declaration pursuant to Section 7 with respect to the alteration of rights of their security holders and the issuance of new securities incident to the proposed merger. Federal Water and Gas Corporation has filed (File No. 34-9) a declaration pursuant to Section 7 with respect to alteration of rights of the holder of its securities incident to the proposed merger. This declaration adopts the application and declaration filed by Federal Water Service Corporation and Utility Operators Company and asks that Federal Water and Gas Corporation be made a party thereto.

[2] Federal Water Service Corporation, the surviving corporation, will change its name to Federal Water and Gas Corporation (the name now borne by its subsidiary).

pany and Federal are registered holding companies. All three corporations are organized under the laws of Delaware.

Utility Operators Company, the top company of what is commonly known as the Federal Water Service system, is solely a holding company. Its only assets are all of the outstanding shares of Federal's Class B common stock, 6,536 shares of the same company's preferred stock, $3,000 principal amount of its debentures, and about $600 worth of miscellaneous assets. Its only outstanding securities are shares of common stock, all owned by officers, directors, and present and former employees of Federal. The company owes no debt.

Federal Water and Gas Corporation has never actively engaged in any business, and its assets are unimportant. All of its outstanding securities, ten shares of common stock of the par value of $100, are owned by Federal. Although not required to register under the Act, Federal Water and Gas Corporation is subject to it in certain respects as a subsidiary of a registered holding company.

Financial Condition of Federal Water Service Corporation

Federal is solely a holding company controlling many subsidiaries which operate water, gas, electric, and other properties in thirteen states and in one foreign country. The following is a table of its outstanding securities:[3]

[3] Here, as throughout, unless otherwise stated, figures are as of December 31, 1940.

Type of Security		Amount
5½% Gold Debentures due 1954		$5,222,000
Preferred stocks (stated values*)		
$7.00 series, 15,296 shares	$1,529,600	
arrearages	990,416	
$6.50 series, 69,888 shares	6,699,282	
arrearages	4,202,016	
$6.00 series, 71,706 shares	6,812,070	
arrearages	3,979,683	
$4.00 series, 2,379 shares	148,688	
arrearages	88,023	
Total preferred stocks		24,449,778
Type of Security		Amount
Class A Stocks**, 568,775 shares		
(exclusive of 1,420 held in the treasury)	$13,666,733	
arrearages	10,617,133	
		24,283,866
Class B stock, 542,450 shares		2,500,000
		$56,455,644

3937 On the balance sheet of Federal Water Service Corporation of December 31, 1939, total assets are stated at $29,915,729, but the investments owned by the corporation are carried at $23,836,361, a figure which the management itself regards as excessive. There are in addition intangible assets which it is proposed to write off in the reorganization.

With total assets stated at an admittedly high figure, there is nevertheless a capital surplus deficit of $3,848,865. In addition, there is a deficit in earned surplus account of $3,865,070. These deficits, totalling $7,713,935, have provided the primary incentive to reorganization, for so long as they impair the capital represented by stock having a preference on the distribution of assets, the payment of dividends on any class of stock will be illegal under Delaware law.[4]

* Involuntary liquidating value is $100 per share plus accrued dividends for all classes of preferred except the $4 series which has an involuntary liquidating value of $62.50 per share plus accrued dividends. Voluntary liquidating value is $110 per share plus accrued dividends for all classes of preferred except the $4 series which has a voluntary liquidating preference of $68.75 per share plus accrued dividends.

** In the event of liquidation the Class A stock is entitled to receive, subject to the prior rights of the preferred stock, $50 per share plus accumulated dividends, and thereafter to share equally with the Class B stock in any remaining assets.

[4] General Corporation Law of Delaware, Section 34 (1935).

There are other factors. The heavy arrearages on the preferred and Class A stocks and the revision in stated value of assets are two others that have already been adverted to. Finally, there are the requirements of Section 11 (b) (2) of the Public Utility Holding Company Act of 1935.

Under this section, it is the duty of the Commission to require, among other things, that each registered holding company and its subsidiaries take such steps as the Commission shall find necessary to insure that their corporate structures do not unfairly or inequitably distribute voting power among security holders. No elaborate demonstration is necessary to establish that the distribution of voting power in Federal violates the statutory standard. Normally, the entire voting power of the company is vested in the Class B stock, but because of dividend arrearages on the preferred and Class A, these stocks have now acquired a majority of the voting rights. The 42.73% of total voting power which still rests in the hand of the B stockholders is clearly unfair and inequitable in view of the fact that the capital deficit entirely wipes out the book value of the Class B stock, and that it has no actual value whatsoever, as we shall show below.

It is also the duty of the Commission, under Section 11 (b) (2), to require each registered holding company to take steps to insure that its corporate structure does not unduly or unnecessarily complicate the structure of the holding company system. The deficits in both capital surplus and earned surplus accounts of Federal, its inability to pay dividends even on its stocks having prior rights, and its large arrearages, provide a combination of complexities which clearly falls within the scope of this section of the Act. For this reason as well as its existing distribution of voting power, Federal was confronted with the prospect of compulsory simplification under Section 11 (b) (2) unless it could succeed in thoroughly revamping its structure by some other permissible method.

3938 *Prior Attempts to Effectuate Reorganization*

The management has recognized the need for reorganization for several years. Even before Federal registered under the Act, discussion between its representatives and members of the Commission's staff had begun, and when Federal registered on November 8, 1937, it immediately filed a plan for reorganization under Section 7 of the Act. The plan now before us is the fourth to be filed by the company, the three previous plans all having been withdrawn, in each case after hearing had been held thereon before a Trial Examiner of the Commission. With respect to none of the earlier plans have there been findings and opinions of the Commission. The record indicates, however, that one of the principal obstacles to the earlier consummation of a reorganization was the issue of allocation of new securities to the Class B stockholders. Each of the plans prior to the present one provided for participation in the equity of the reorganized company by the Class B stockholders (either immediately or upon the exercise of purchase warrants for additional stock).

The present plan, the first to involve the merger of Utility Operators Company and Federal Water and Gas Corporation with Federal, was filed on March 30, 1940. The application states that the merger device was used in view of a recent decision of the Supreme Court of Delaware in *Havender* v. *Federal United Corporation*,[5] which established the propriety under Delaware law of directly affecting accrued dividends on preferred stocks in a merger, in contrast to the position taken by the Delaware courts with respect to similar action by charter amendment.[6]

After due notice hearings were held on the applications and declarations herein before a trial examiner of the Commission.[7] Tentative findings and opinion were prepared by

[5] 11 A. 2d 331 (Del. 1940).

[6] *Cf. Keller* v. *Wilson & Co.*, 190 A. 115 (Del. 1936); *Consolidated Film Industries, Inc.* v. *Johnson*, 197 Atl. 489 (Del. 1937).

[7] William S. Fox and Louis Russo, representing themselves and other holders of Class A stock appeared and were heard. A brief was filed by counsel to Mr. Russo.

the Commission (in which Commissioner Healy did not participate) and distributed to the parties. Thereafter, counsel to Federal and counsel to the Commission filed briefs and were heard in oral argument before the Commission.

Outline of Present Plan

As already pointed out, Utility Operators Company and Federal Water and Gas Corporation are to be merged into Federal.[8]

The Proposed Participation by Present Holders of Securities

The debentures of Federal Water Service Corporation are to remain undisturbed by the plan except for a small change in amount.[9] The present stockholders of Federal Water Service Corporation and the common stockholders of Utility Operators Company[10] are to receive new common stock, which the declaration states will have a par value of $12 per share, as indicated in the following table:

TABLE.

	Shares to be Converted	New Common Shares Rate	New Common Shares Number	New Common Par Value (at $12 per Share)	Per Cent
Federal Water Service Corporation:					
$7.00 Preferred	14,355	7	100,485	$1,205,820	9.50
$6.50 Preferred	67,640	6½	439,660	5,275,920	41.54
$6.00 Preferred	68,390	6	410,340	4,924,080	38.77
$4.00 Preferred	2,348	4	9,392	112,704	.89
Total Preferred	152,733		959,877	$11,518,524	90.70%
Class A	568,775	1/10	56,877	682,524	5.38
Utility Operators Company:					
Common	56,428 9/19	.7357*	41,514	498,168	3.92
			1,058,268	$12,699,216	100.00%

[8] Upon consummation of the merger, Federal Water Service Corporation is to change its name to Federal Water and Gas Corporation.

[9] The face amount of debentures outstanding of the reorganized corporation will be $5,259,000 instead of $5,262,000. (These figures should be reduced by $40,000 for debentures purchased in 1940). $3,000 of debentures now owned by Utility Operators Company will be cancelled.

[10] The ten outstanding shares of Federal Water and Gas common, all owned by Federal, are to be cancelled; so are the 1420 shares of its own Class A which Federal holds in its treasury; so, too, are all of the shares of Federal of all classes held by Utility Operators Company (including all of the Class B stock, entirely owned by Utility Operators Co.).

*This ratio is explained immediately below in the text.

None of the new common stock allocated to Utility Operators is allotted in recognition of its own stock or its ownership of all of Federal's Class B stock, which it is to surrender for cancellation. The allocation to Utility Operators of 3.92% of the new common stock is based almost[11] entirely upon its holdings of 6,536 shares of Federal preferred and the application of the same conversion rates, set forth in the above table, which were applied to other holdings of preferred. Hence, except for the 5.38% of new common allocated to the present holders of Class A stock, substantially all of the equity of the reorganized company will be given to the present preferred stockholders.

The declaration states that the new stock is to have a par value of $12 per share, and that 1,500,000 shares are to be authorized, of which it is contemplated that 1,058,268 will be issued, as shown in the above table.[12]

3940 Under the plan the intangible items, "commission on capital stock" and "organization expense", which are presently carried on the books at $1,444,221.16 and $424,732.50 respectively, will be written off the books, and the assets of the surviving corporation will be recorded on the books at their reasonable value as determined by the board as of the date of the merger,[13] and such capital surplus as the recorded value of assets permits will be re-

[11] 300 shares of the new common represent consideration for the $3,000 in debentures of Federal, which are being cancelled, and $600 of other assets.

[12] Section 61 of the General Corporation Law of Delaware provides that a stockholder who objects to a merger and complies with applicable statutory provisions may receive the value of his stock from the surviving corporation. To the extent that this privilege is exercised in the present case the number of shares of new common to be issued will be reduced. If holders of 3,000 or more shares of Federal Preferred, irrespective of series, object to the merger, the boards of directors of both Federal and Utility Operators Company reserve the right to abandon the proposed plan.

[13] A write-down of approximately six million dollars in the value of investments is contemplated.

corded. The following table shows the balance sheets of Federal Water Service Corporation and Utility Operators Company as at December 31, 1939, and a pro forma balance sheet of the surviving company as of the same date,[14] giving effect to the merger:

	Federal Water Service Corporation	Utility Operators Company	Pro Forma * Federal Water and Gas Corporation (surviving company)
Investments	$24,406,757	$ 187	$17,607,808
Less—Reserve	570,396	.....	.....
Net investments	$23,836,361	$ 187	$17,607,808
Investment in Federal	.....	690,320	.....
Special Funds	262,238	.....	262,238
Current assets:			
Cash	3,660,437	1,012	3,661,449
Other	258,023	28	258,022
Commission on capital stock	1,444,221	.....	.....
Organization expense	424,733	.....	.....
Office furniture and fixtures	29,716	.....	29,716
Total assets	$29,915,729	$691,547	$21,819,233
Liabilities			
5½% unsecured debentures	$ 5,262,000	.....	$ 5,259,000
Current liabilities	502,967	428	503,367
Miscellaneous reserves	508,323	.....	508,323
Capital stock:			
Preferred	15,189,640	.....	.....
Class A	13,666,734	.....	.....
Class B	2,500,000	.....	.....
Common	.....	282,145	12,699,216
Capital surplus	(3,848,865)	409,967	2,849,327
Earned surplus	(3,865,070)	(993)	.....
Total liabilities	$29,915,729	$691,547	$21,819,233

3941 The plan also provides that the present directors of Federal Water Service Corporation shall be the first directors of the surviving corporation, and that the election of new directors shall be "staggered" as follows: of the seven present directors, two shall remain in office

[14] The record is not complete enough to present this comparison as of December 31, 1940.

* Assuming no holders of stock now outstanding avail themselves of statutory provisions entitling objecting stockholders to require purchase of their shares.

until the next annual meeting of stockholders following the effective date of the merger agreement; two others, for one year thereafter; and the remaining three, for two years thereafter. The present board was chosen by the Class B stockholders. Under the proposed arrangement, the holders of new common will not be able to elect a majority of directors for approximately two years, control in the meantime continuing in the remaining members of the present board.

* * * * * * * * * *

Preferred Stock Purchases by Directors and Officers.

3952 A further question as to the fairness of the plan arises with respect to the participation to be accorded to preferred stock held by members of the management of Federal. The plan of reorganization herein considered, like previous plans filed with us over the past several years, was formulated by the management of Federal, and discussions concerning the reorganization of this corporation have taken place between the management and the staff of the Commission over the past several years. C. T. Chenery, president of the debtor, and a corporation owned by his family purchased 8,618 shares of Federal preferred stock between November 8, 1937, when the first plan was filed with us, and June 30, 1940. These purchases were made on the over-the-counter market through brokers at prices ranging from 16½ to 34 for the $6.00 preferred. Very few of the shares were bought at prices higher than 30 and a substantial portion of them was purchased at prices in the low 20's. Other officers and directors of Federal and of Utility Operators Company acquired 3,789 shares during the same period at prices at the same general level.

The following table shows the purchases made between November 8, 1937, and June 30, 1940, the amount paid and the book value of the new common shares for which this preferred would be exchanged:

	$7.00	$6.50	$6.00	Total	Cost	No. of Common Shares	Book Value of the Common to be Received In Merger
C. T. Chenery	1,211	3,547	3,860	8,618	$240,148.01	54,692	$803,972.40
Other Officers and Directors of Federal Utility Operators Company	255	2,793	741	3,789	88,198.88	24,385	358,459.50
	1,466	6,340	4,601	12,407	$328,346.89	79,077	$1,162,431.90

Under the proposed plan, the preferred shares so purchased would participate in the plan on a parity with all other shares of preferred stock of the same series. We have come to the conclusion that this feature of the plan cannot be approved.

In reaching this conclusion, we have not failed to take into consideration the fact that after individual stockholders had made complaint of the management's purchases, the officers and directors agreed upon a policy of deferring individual purchases while particular plans were in contemplation but had not been made public. An honest effort appears to have been made to adhere to this policy.

3953 But we do not think that this fact was enough. Corporate directors are fiduciaries—their powers are powers in trust. *Pepper* v. *Litton*, 308 U. S. 295. We hold further that in the process of formulation of a "voluntary" reorganization plan, the management of a corporation occupies a fiduciary position toward all of the security holders to be affected, and that it is subjected to the same standards as other fiduciaries with respect to dealing with the property which is the subject matter of the trust. Of course, the management does not hold title to the securities, but its duty of fair dealing with the persons for whom it acts is as great as if that of a trustee who holds title to a *res* for the benefit of his beneficiaries.[36] A trustee

[36] *In re Standard Commercial Tobacco Co., Inc.*, 34 F. Supp. 304, 310 (S. D. N. Y. 1940) and cases cited. Compare Berle and Means, *The Modern Corporation and Private Property* 1 (1932) c. VII, *Corporate Powers as Powers in Trust*. Compare also sec. 16(b) of the Securities and Exchange Act of 1934 and sec. 17 (b) of the Public Utility Holding Company Act of 1935, which recognize the fiduciary character of the management—officers, directors, and principal stockholders—and its opportunity to use inside information, by providing that any profits made on purchases and sales, or sales and purchase, within six months should inure to the benefit of the corporation.

may not "become the purchaser of the property which he represents or any portion of it though he has done so for a fair price without fraud at a public sale." *Michoud* v. *Girod*, 4 How. 502, 557 (1846). Accordingly, honesty, full disclosure and purchase at a fair price do not take the case outside the rule. The need for an inflexible rule was recognized in *Michoud* v. *Girod, supra:*

"Is it not better that the cause of the evil shall be prohibited, than that courts of equity shall be relied upon to apply the remedy in particular cases, by inquiring into all the circumstances of a case, whether there has or has not been fraud in fact?" (At 557.)

Or, as the Supreme Court later stated in *Magruder* v. *Drury*, 235 U. S. 106, 119, 120 (1914):

"The rule in such cases springs from his duty to protect the interests of the estate, and not to permit his personal interest to in any wise conflict with his duty in that respect. The intention is to provide against any possible selfish interest exercising an influence which can interfere with the faithful discharge of the duty which is owing in a fiduciary capacity. . . . It makes no difference that the estate was not a loser in the transaction or that the commission was no more than the services were reasonably worth."

In *Meinhard* v. *Salmon*, 249 N. Y. 458, Chief Justice Cardozo said:

"Many forms of conduct, permissible in a work-a-day world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morale of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this, there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion'
3954 of particular exceptions. Only thus, has the level of conduct for fiduciaries been kept at a level higher

than that trodden by the crowd. It will not consciously be lowered by any judgment of this court."

These principles have been applied to persons whose fiduciary position arises from the fact that they act for others in the formulation of a reorganization plan. The principles have been codified in Section 249 of the Bankruptcy Act, but the application of the principle does not depend on the existence of a statute. It depends on the broad equitable principles enunciated in the cases heretofore cited. See *Woods* v. *City National Bank & Trust Co. of Chicago*, Supreme Court of the United States, decided February 3, 1941. Indeed, Section 249 of the Bankruptcy Act is merely declaratory of the position taken by the federal courts under Section 77B of the Bankruptcy Act as applied to dealings by reorganization committee members in the securities of the corporation being reorganized. See *In the Matter of Mountain States Power Co.* (C. C. A. 3d, March 5, 1941), *aff'g.* 35 Supp. 307 (D. Del. 1940); *Otis & Co.* v. *Insurance Bldg. Corp.*, 110 F. (2d) 333 (C. C. A. 1st, 1940); *In re Paramount Publix Corporation*, 12 F. Supp. 823, 828 (S. D. N. Y. 1935), cited with approval in *American United Mutual L. Ins. Co.* v. *City of Avon Park Florida*, 61 S. Ct. 157, decided Nov. 25, 1940; *In re Republic Gas Corporation*, 35 F. Supp. 300 (S. D. N. Y. 1936). The result of these cases does not depend on dishonesty or unfair dealing, for it was conceded in the *Otis* case, *supra*, that the brokerage house which acted as committee had lost money in the transactions, that it had acted in good faith, that the sellers of the bonds knew that the house was representing the bondholders, and that it had entered into the transactions "for the accommodation" of its customers. Similar facts appeared in the *Mountain States* case. In the *Republic* case Judge Caffey said:

"'Because of the inconsistent positions which are an unavoidable incident, it is a fraud in law for a trustee to purchase property which is the subject matter of his trust and the making of such a purchase is misconduct."

* * * * * * * * * *

"There is no blinking the fact that the ground on which the court denounces as a fraud the purchase by a trustee of trust property is that it inevitably brings about conflict of interest between himself personally and the beneficiaries of his trust; or at least that it incites a motive, *or affords opportunity for a motive*, on the part of the trustee to take advantage of his superior knowledge acquired in his trust capacity, which may induce him to conceal his information from the beneficiaries or not to employ it exclusively for their benefit, while they are relying on him scrupulously to devote himself to the furtherance of their welfare (*Michoud* v. *Girod*, *supra*, pp. 554, 555, 559)."

. . . . . .

"I believe that only by rigid enforcement of that duty can the continuance or reinstatement of old evils, which were of general knowledge, be prevented or, if prevention prove impossible, be minimized."

. . . . . .

". . . Furthermore, if, as I deem it established, the misconduct amounts to a fraud in law, I conceive of no good reason why the penalty for the fraud should not be denial of any compensation whatever for those services. Indeed, I feel that the only available device for promoting, if not assuring, justice to depositing bondholders in the man-
3955 agement of their affairs, and thus of restoring or attempting to restore faith in deposit agreements, is strict application to committeemen of the ancient equity rules governing the conduct of trustees, including deprivation of compensation where there is a departure from those rules."

. . . . . .

"It may well be that there are some who, without veering away from the utmost faithfulness, could safely be left free to trade in bonds which are the subject matter of their trusts. Nevertheless, the danger of the contrary is so manifest, the bondholders themselves generally are so helpless and the hurt to them is or may be so serious that, in order to protect against the evil, or the possibility of the evil,

from which bondholders have suffered so greviously in the past, and which Congress intended to bring to an end, the court should inflexibly enforce the rule that members of committees shall not trade in the securities with respect to which they are acting or undertaking to act in behalf of the owners."

We think that the authorities heretofore cited are fully applicable to the position of the management of a corporation trading in the securities which will be affected by a voluntary plan of reorganization upon which the management is working. We, no more than a court of equity, should undertake to decide case by case whether the management's trading has in fact operated to the detriment of the persons whom it represents. As the Supreme Court said in *Woods* v. *City National Bank & Trust Co. of Chicago*, *supra*:

"... It is no answer to say that fraud or unfairness were not shown to have resulted. Cf. *Jackson* v. *Smith*, 254 U. S. 586, 589. The principle enunciated by Chief Justice Taft in a case involving a contract to split fees in violation of the bankruptcy rules, is apposite here: 'What is struck at in the refusal to enforce contracts of this kind is not only actual evil result but this tendency to evil in other cases.' *Weil* v. *Neary*, 278 U. S. 160, 173. . . ."

The remedies to be applied in particular cases may be chosen with utmost flexibility. In the *Otis & Company*, *Mountain States Power*, *Paramount Publix and Republic Gas* cases, *supra*, the questions arose on the applications of fiduciaries for fees and in all cases the fees were disallowed.[37] In this case no application for fees is presented to

[37] This treatment demonstrates that no attempt is made to apportion the remedy to the injury done, but the standard of fiduciary conduct is enforced by denying *all* opportunity for profit to fiduciaries who trade in the securities with respect to which they have the fiduciary duty. Compare section 16 (b) of the Securities Exchange Act of 1934 and section 17 (b) of the Public Utility Holding Company Act of 1935, which, for the purpose of preventing the unfair use of inside information by directors, officers, and other insiders, provide that any profit made by them on purchase and sales, or sales and purchases, within six months, shall inure to the benefit of the corporation, regardless of the existence of overreaching or the amount thereof in the particular case.

ns, but other remedies may be appropriate. As Mr. Justice Douglas said in *American United Mutual Life Insurance Company* v. *City of Avon Park, Florida* (61 S. Ct. 157), decided November 25, 1940:

3956 "... When such investigation discloses the existence of unfair dealing, a breach of fiduciary obligations, profiting from a trust, special benefits for the reorganizers, or the need for protection of investors against an inside few or one class of investors from the encroachment of another, the court has ample power to adjust the remedy to meet the need. The requirement of full, *unequivocal disclosure; the limitation of the vote to the amount paid for the securities* (*In re McEwen's Laundry, Inc.*, 90 F. (2d) 872); the separate classification of claimants (see *First National Bank* v. *Poland Union*, 109 F. (2d) 54, 55); the complete subordination of some claims (*Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307; *Pepper* v. *Litton*, *supra*), indicate the range and type of the power which a court of bankruptcy may exercise in these proceedings. That power is ample for the exigencies of varying situations. *It is not dependent on express statutory provisions.* It inheres in the jurisdiction of a court of bankruptcy. The necessity for its exercise (*Pepper* v. *Litton*, *supra*, p. 308) is based on the responsibility of the court before entering an order of confirmation to be satisfied that the plan in its practical incidence embodies a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle. . . ." (Italics supplied.)

Similarly, deciding whether the terms of issuance of the new common stock are fair and equitable or are detrimental to the interests of investors, we must find that they are unfair, inequitable, and detrimental, so long as the preferred stock purchased by the management at low prices is to be permitted to share on a parity with other preferred stock. In this respect this case closely resembles the *Avon Park* case itself. That case involved a municipal composition under Chapter IX of the Bankruptcy Act. R. E. Crum-

mer & Co., the city's fiscal agent, purchased obligations of the city at about 50 cents on the dollar, both before and after execution of the fiscal agency contract. In holding that the plan had been improperly confirmed, the Supreme Court ruled not only that all of the benefit to be obtained by the fiscal agent from the securities purchased had to be considered in determining whether its aggregate compensation was reasonable, but also that any excess benefits accruing to the fiscal agent would make the plan unfair and inequitable because it would discriminate in his favor as a creditor. See also *In re Norcor Mfg. Co.*, 109 F. (2d) 407 (C. C. A. 7th, 1940); *In re McCrory Stores Corp.*, 12 F. Supp. 267 (S. D. N. Y. 1935).[38]

3957 We believe that a formula should be devised which will limit the participation of the preferred stock purchased by the management to an amount which takes into account the purchase prices paid, plus accumulated dividends since the dates of the respective purchases. We do not now attempt to indicate what that formula should be, since the matter is complicated by the fact that the apportionment of stock among the several series of preferred stocks is to be based upon their respective dividend rates and dividend accumulations rather than upon their liqui-

[38] Compare sec 77B (b) of the Bankruptcy Act, which provided that "the judge . . . may limit any claims filed by such committee member or agent, to the actual consideration paid therefor" and sec. 212 of Chapter X of the Bankruptcy Act, which provides that "the judge . . . may limit any claim or stock acquired by any such person or committee in contemplation or in the course of the proceeding under this chapter to the actual consideration paid therefor."

We do not read the *Avon Park* case or the other cases cited as holding that in no case may a claimant receive parity treatment for securities purchased at a discount during the reorganization. Such parity treatment is the usual rule. *Security First National Bank of Los Angeles* v. *Ridge Land & Navigation Co.*, 85 F. (2d) 557 (C. C. A. 9th, 1936), rehrg. denied, 86 F. (2d) 3, certiorari denied, 299 U. S. 613, rhrg. denied, 300 U. S. 686; *Texas Hotel Securities Corporation* v. *Waco Development Co.*, 87 F. (2d) 395 (C. C. A. 5th), certiorari denied, 300 U. S. 679, rhrg. denied, 301 U. S. 713; *In re Utilities Power & Light Corporation*, 29 F. Supp. 763, 770 (N. D. Ill.), app. dism., C. C. A. 7th on March 9, 1940; *In re Radio-Keith-Orpheum Corporation*, 106 F. (2d) 22, 27 (C. C. A. 2d). Cf. *In re Tennessee Publishing Co.*, 81 F. (2d) 463, 466 (C. C. A. 6th), aff'd, 299 U. S. 18; *Cromwell* v. *County of Sac*, 96 U. S. 51, 60; and *Wade* v. *Chicago, Springfield & St. Louis R. R. Co.*, 149 U. S. 327, 343. We think the principle involved in the *Avon Park* case is limited to purchase during reorganization in violation of fiduciary duty. Compare the provisions of sec. 77B (b) and sec. 212 of the Bankruptcy Act, *supra*, which are limited to persons acting in a fiduciary capacity.

dation values. Our staff will be available for consultation with Federal with respect to this matter, and we shall give further consideration to this question if and when Federal files amendments to its proposal.

For the present we deny effectiveness to these declarations because we must enter adverse findings under sections 7 (d) (1) and 7 (d) (2) so long as the par value of the proposed common stock is fixed as high as $12 per share; because we find that the provisions with respect to the board of directors of the surviving company would result in an unfair distribution of voting power; and because we find that the provisions for participation by the preferred stock held by the management result in the terms of issuance of the new securities being detrimental to the interests of investors and the plan being unfair and inequitable. We shall withhold entry of an order refusing to permit the declarations to become effective for a period of 30 days. If during that time Federal files amendments to its proposal designed to cure the defects in its plan which we have pointed out, we shall give further consideration to the matter. If within such time amendments are not filed, we shall enter an order refusing to permit the declarations to become effective.

By the Commission (Chairman Frank and Commissioners Eicher and Pike), Commissioner Healy dissenting (see separate opinion below) and Commissioner Henderson being absent and not participating.

(S) FRANCIS P. BRASSOR,
Secretary.

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Excerpts from amendment No. 15 to application pursuant to rule U-12 E-4 for a report on a plan of reorganization and declaration (Docket No. 18).

(filed August 12, 1941)

1066 FEDERAL WATER SERVICE CORPORATION

90 Broad Street
New York, N. Y.

September —, 1941.

To the Stockholders of
Federal Water Service Corporation:

There is enclosed herewith a notice of a special meeting of stockholders which has been called to consider and act on a plan for the readjustment and simplification of the capital structure of Federal Water Service Corporation by means of and in connection with a merger between Federal Water Service Corporation, Utility Operators Company and Federal Water and Gas Corporation. The plan is embodied in a merger agreement which has been executed on behalf of the three corporations by their respective boards of directors, and copy of which is annexed hereto, marked "Exhibit A."

. . . . . .

1071 *Decision of the Securities and Exchange Commission as to Preferred Stock Purchased by Officers and Directors.*

Certain of the officers and directors of Federal Water Service Corporation and Utility Operators Company purchased Preferred stock of Federal Water Service Corporation in the market during the period from November 8, 1937 (the date when the first plan for the reorganization of Federal Water Service Corporation was filed with the Se-

curities and Exchange Commission), and June 10, 1940 (the date of the last purchase by any officer or director).

On June 29, 1940, the Securities and Exchange Commission handed down tenfative findings and opinion with respect to the merger plan in which the question was raised whether such Preferred stock was entitled to participate in the reorganization on the same basis as Preferred stock owned by others. Hearings held in July, 1940, at which full testimony was given as to these purchases. It was undisputed that the stock had been purchased in the over-the-counter market at prevailing prices, with the exception of one instance where stock had been purchased directly by negotiation, as to which the person conducting the negotiations on behalf of the owners testified that he was fully acquainted with the facts with respect to the value of the stock; that he was entirely satisfied with the sale, and that he believed strongly in the management. On March 24, 1941, the Commission handed down its findings and opinion and held that a plan could not be approved, if it treated the stock purchased by officers or directors of the corporation and of Utility Operators Company after November 8, 1937 on a parity with the Preferred stock held by others. The Commission's opinion suggested that its staff was available for consultation with the management as to the formula which should be applied to deal with such stock. After consultation with the staff it appeared that the Commission would approve a plan which required all persons who, after November 8, 1937, purchased Preferred stock of Federal Water Service Corporation at a time when they were directors or officers of Federal Water Service Corporation or Utility Operators Company to surrender the stock so purchased to the Corporation on payment by it to them of the cost of the stock to them, plus interest on this cost at 4% per annum. Paragraph Fourth (d) of the merger agreement provides for such acquisition. The Commission's staff also requested that each person affected by the Commission's decision execute an agreement obligating him to hold

the Preferred stock purchased since November 8, 1937 so that if the merger agreement became effective before that time it would operate upon this stock. Although strongly believing that the decision of the Commission with respect to their stock was unfair and unauthorized by the Public Utility Holding Company Act, the directors and officers affected have given such agreements in form satisfactory to the staff of the Securities and Exchange Commission, obligating them to hold such stock and not sell or otherwise dispose of the same until November 1, 1941 unless prior to that date the merger agreement becomes effective or is abandoned.

Two of the officers who purchased Preferred stock after November 8, 1937, sold part of this Preferred stock in the market. Paragraph Fourth (d) of the merger agreement requires those officers to turn over to the surviving corporation the profits realized upon these sales by providing for the acquisition of their remaining stock purchased after November 8, 1937 at a price which is determined by subtracting from the cost of all stock purchased after November 8, 1937, plus interest at 4%, the proceeds of sale of any stock theretofore sold, plus interest from the sale date to the effective date of the merger agreement. One officer of Utility Operators Company who had sold all of the Preferred stock purchased by him after November 8, 1937 after he became an officer of such company (30 shares) has given his check for the amount of the profit on such sale ($94.35) to be cashed if the merger agreement becomes effective before November 1, 1941. He has also agreed to pay to the surviving corporation interest at 4% on this amount from the date of the sale to the date the merger agreement becomes effective.

1072 The Public Utility Holding Company Act of 1935, Section 17, contains an express provision with respect to purchases and sales by officers and directors of securities of a holding company or a subsidiary, and provides that profits realized within six months after the purchase

of the security may be recovered for the benefit of the corporation. It also provides for reports to be made to the Securities and Exchange Commission as to all purchases and sales. Reports were made from time to time to the Securities and Exchange Commission in pursuance of the Act and the rules of the Commission. No objection was raised to any of the purchases by anyone on behalf of the Securities and Exchange Commission until, as above stated, the question was raised in the tentative findings and opinion of the Commission on June 29, 1940.

One of the provisions of the agreements which have been executed by officers and directors purchasing this stock is as follows:

"That this instrument shall not be construed as a waiver of any right that I may have to review in the manner provided by law any decision of the Securities and Exchange Commission or to take such action as I may be advised to protect my rights as they may be established on such review."

It is probable that one or more of those purchasing Preferred stock after November 8, 1937, and whose stock so purchased has been required by the plan to be surrendered to the surviving corporation, will bring proceedings to review the decision of the Securities and Exchange Commission directing this treatment of their stock. The pendency of any such proceedings will not, however, affect the consummation of the plan. If, on appeal by such officers or directors, it should be held that the Securities and Exchange Commission has acted illegally and beyond its authority in this matter, it is believed that such Preferred stock should be permitted to participate in the reorganization on the same basis as other Preferred stock.

The total number of shares of Preferred stock of officers and directors to be acquired by the surviving corporation pursuant to the merger agreement aggregates 11,598 and

the purchase price of these shares, computed pursuant to paragraph Fourth (d) of the merger agreement, with interest to October 31, 1941, is estimated by the corporation at $313,091.99.

Exhibit A, Federal Water Service Corporation, Merger Agreement.

Fourth: * * * *

1083 (d) No shares of comon stock of the surviving corporation shall be issued in lieu of the shares of preferred stock of Federal Water Service Corporation purchased since November 8, 1937 by Chenery Corporation, or since November 8, 1937 by the following persons when they were officers or directors of Federal Water Service
1084 Corporation or Utility Operators Company and which are owned by them on the effective date of the merger agreement: J. N. Greene, W. R. Edwards, C. M. Chenery, H. G. Calder, C. P. Rather, R. H. Neilson, Wm. E Matthews, III, Watson Dark, E. C. Deal, H. M. Erskine, F. T. Tansill, F. R. Harris, W. A. Culin, H. D. McHenry, T. H. Wiggin, E. C. Elliott and C. van den Berg, Jr. Each such holder shall be entitled to receive and the surviving corporation shall be obligated to pay, upon the surrender of the certificates of such stock to the surviving corporation, the actual cost of such stock to such holder, together with interest thereon at four per cent per annum from the dates of its or his purchase of such stock to the effective date of the merger agreement In ascertaining cost of preferred stock acquired by exchange of other securities for purposes of this provision, the fair market value at the date of exchange of the securities given in exchange shall be deemed to be the cost of such preferred stock. In the event any shares of preferred stock of Federal Water Service Corporation purchased by Chenery Corporation or by the said officers or directors of Federal Water Service Corporation or Utility Operators Company since November 8, 1937,

shall have been sold by such corporation or individual prior to the effective date of the merger agreement, the surviving corporation shall, upon the surrender of the remaining such shares owned by such corporation or individual, be obligated to pay to such corporation or individual a sum equal to the actual cost of all preferred stock of Federal Water Service Corporation purchased by it or him since November 8, 1937, together with interest thereon at four per cent per annum from the dates of its or his purchase of such stock to the effective date of the merger agreement minus the proceeds of the sale by it or him of any such shares together with interest thereon at four per cent per annum from the dates of its or his sale of such stock to the effective date of the merger agreement. The shares of preferred stock to be acquired by the surviving corporation pursuant to this subdivision (d) of the merger agreement consist of 4,522 shares of preferred stock of Federal Water Service Corporation of the $6 series, 5,610 shares of the $6.50 series and 1,466 shares of the $7 series.

* * * * * * * * * *

3977 **Application by Chenery Corporation, et al. for Leave to Intervene, and Request for Reconsideration and Relief.**

(filed August 15, 1941)

Now come Chenery Corporation, H. M. Erskine, R. H. Neilson, W. A. Culin, F. T. Tansill, H. D. McHenry, T. H. Wiggin, C. M. Chenery, J. N. Greene, H. G. Calder, C. P. Rather, William E. Matthews, III, C. van den Berg, Jr., W. R. Edwards, Watson Dark, E. C. Deal, F. R. Harris, and E. C. Elliott, hereinafter called "interveners", and make application for permission to intervene in the above entitled proceeding, and as reason therefor state:

1. Chenery Corporation is a corporation organized under the laws of Delaware with offices at 1 Exchange Place, Jer-

sey City, New Jersey, and is a stockholder in Federal Water Service Corporation (hereinafter called
3978 "Federal"). The President of Chenery Corporation is C. T. Chenery, who is also the President and a director of Federal and of Utility Operators Company (hereinafter called "UOC"). Chenery Corporation has outstanding 22,937 shares of stock of which 9,637 shares are owned by C. T. Chenery, 1,100 shares are owned by C. M. by William L. Chenery, 1,100 shares are owned by Alan J. Chenery, 1,100 shares are owned by Blanche B. Perrin, 600 shares are owned by Hollis Burnley Chenery, 600 shares are owned by Margaret Emily Chenery, 600 shares are owned by Helen Bates Chenery (Jr.), and 7,100 shares are owned by Helen Bates Chenery. The stockholders of Chenery Corporation other than C. T. Chenery and C. M. Chenery are not officers or directors of Federal, of UOC or of Federal Water and Gas Corporation (hereinafter called "FW & G").

2. The interveners other than Chenery Corporation are officers or directors of Federal, UOC, and FW & G, as follows: H. M. Erskine is Vice President and a director of Federal. R. H. Neilson is a director and Vice President of UOC. W. A. Culin is Vice President, Treasurer, and a director of Federal, a director of UOC, and the President and a director of FW & G. F. T. Tansill is Vice President and Secretary of Federal, Secretary and Treasurer and a director of UOC, and Secretary and Treasurer and a
3979 director of FW & G. H. D. McHenry is a Vice President of Federal and a Vice President and director of FW & G. T. H. Wiggin is a former director of UOC. C. M. Chenery is a director of UOC. The address of the seven persons just named is 90 Broad Street, New York City. J. N. Greene is a director and Vice President of UOC. H. G. Calder is a director of UOC. C. P. Rather is a director and Vice President of UOC. William E. Matthews, III is a director and Vice President of UOC. C. van den Berg,

Jr. is a former Vice President and director of Federal and a former Vice President and director of UOC. The address of the five persons just named is Watts Building, Birmingham, Alabama. W. R. Edwards is a director of UOC, address Triangle Building, Rochester, New York. Watson Dark is a director of UOC, address Miami Beach, Florida. E. C. Deal is a Vice President and director of UOC, address 135 Jefferson Avenue, Scranton, Pennsylvania. F. R. Harris is a former director of Federal, address 27 William Street, New York City. E. C. Elliott is a former director of UOC, address San Francisco, California.

3. These proceedings involve applications and declarations having as their primary object the reorganization of Federal pursuant to a plan contemplating the merger of UOC the parent of Federal, and FW & G, a wholly owned subsidiary of Federal, into Federal. In the above entitled proceeding Federal filed (File No. 34-9) an application pursuant to Rule U-12E-4 for a report on a plan for its reorganization, and a declaration pursuant to Rule U-12E-5 with respect to solicitation of consents to this plan. UOC filed (File No. 34-41) a similar application and declaration. Federal and UOC jointly filed (File No. 79-28) a declaration pursuant to Section 7 with respect to the alteration of rights of their security holders and the issuance of new securities incident to the proposed merger. FW & G filed (File 34-9) a declaration pursuant to Section 7 with respect to alteration of rights of the holder of its securities incident to the proposed merger. This declaration adopts the application and declaration filed by Federal and UOC and asks that FW & G be made a party thereto. The first plan was filed in these proceedings November 8, 1937. Successive amendments have been filed to the application and declarations, and the proceedings are still pending, no final order having been entered therein.

3980

4. During the period from November 8, 1937, to June 30, 1940, these interveners purchased preferred stock in Federal in amounts as follows:

3981

Name	Shares $6.00 Preferred	$6.50 Preferred	$7.00 Preferred
J. N. Greene	45	..	..
W. R. Edwards	100	..	..
H. G. Calder	..	40	..
C. P. Rather	110	310	..
R. H. Neilson	10	..	..
Wm. E. Matthews III	..	65	..
Watson Dark	5	160	60
E. C. Deal	85	..	..
H. M. Erskine	25	50	..
F. T. Tansill	..	65	..
F. R. Harris	130	173	40
W. A. Culin	50	110	..
H. D. McHenry	..	75	15
Chenery Corporation	3860	3547	1211
T. H. Wiggin	50	30	..
E. C. Elliott	27	..	..
C. M. Chenery	150	170	..
C. van den Berg, Jr.	25	1535	140

C. M. Chenery has sold 125 shares of the $6.00 preferred stock and 20 shares of the $6.50 preferred stock, C. van den Berg, Jr. has sold 25 shares of the $6.00 preferred stock and 700 shares of the $6.50 preferred stock.

5. These proceedings have been pending before the Commission since November 8, 1937, and numerous hearings have been had thereon. March 24, 1941, the Commission filed its findings and opinion therein (Holding Company Act Release No. 2635). The plan then under consideration had contemplated, among other features, the conversion of Federal $7 preferred, $6.50 preferred, $6.00 preferred and

$4.00 preferred into new common stock. In its find-
3982 ings and opinion filed March 24, 1941, the Commission stated that the plan of reorganization could not be approved in so far as it provided for participation of preferred shares purchased by officers or directors of Federal or UOC, or by the Chenery Corporation after November 8, 1937, on a parity with other shares of preferred stock of the same series. The Commission found that "the provisions for participation by the preferred stock held by the management result in the terms of issuance of new securities being detrimental to the interest of investors and the plan being unfair and inequitable". Entry of an order was deferred, and it was stated that further consideration would be given to the matter if Federal filed amendments to its proposed plan designed to cure this and other alleged defects therein.

6. Thereafter amendments to the declarations and applications setting for the plan of reorganization were filed by the corporations involved in order to comply with the said findings and Opinion of the Commission as interpreted by the staff of the Commission. Paragraph Fourth (a) of the proposed merger agreement as set forth in the last amendments (see No. 15) reads as follows:

FOURTH: The manner of converting the shares of cap-
ital stock of each of the constituent corporations into
3983 share of stock of the surviving corporation shall be as follows:

* * * * * * * * * *

(d) No shares of common stock of the surviving corration shall be issued in lieu of the shares of preferred stock of Federal Water Service Corporation purchased since November 8, 1937 by Chenery Corporation, or since November 8, 1937 by the following persons when they were officers or directors of Federal Water Service Corporation or Utility Operators Company and which are owned by them on the effective date of the merger agreement: J. N.

Greene, W. R. Edwards, C. M. Chenery, H. G. Calder, C. P. Rather, R. H. Neilson, Wm. E. Matthews, III, Watson Dark, E. C. Deal, H. M. Erskine, F. T. Tansill, F. R. Harris, W. A. Culin, H. D. McHenry, T. H. Wiggin, E. C. Elliott and C. van den Berg, Jr. Each such holder shall be entitled to receive and the surviving corporation shall be obligated to pay, upon the surrender of the certificates of such stock to the surviving corporation, the actual cost of such stock to such holder, together with interest thereon at four per cent per annum from the dates of its or his purchase of such stock to the effective date of the merger agreement. In ascertaining cost of preferred stock acquired by exchange of other securities for purposes of this provision, the fair market value at the date of exchange of the securities given in exchange shall be deemed to be the cost of such preferred stock. In the event any shares of preferred stock of Federal Water Service Corporation purchased by Chenery Corporation or by the said officers or directors of Federal Water Service Corporation or Utility Operators Company since November 8, 1937, shall have been sold by such corporation or individual prior to the effective date of the merger agreement, the surviving corporation shall, upon the surrender of the remaining such shares owned by such corporation or individual, be obligated to pay to such corporation or individual a sum equal to the actual cost of all preferred stock of Federal Water Service Corporation purchased by it or him since November 8, 1937, together with interest thereon at four per cent per annum from the dates of its or his purchase of such stock to the effective date of the merger agreement minus the proceeds of the sale
3984 by it or him of any such shares together with interest thereon at four per cent per annum from the dates of its or his sale of such stock to the effective date of the merger agreement. The shares of preferred stock to be acquired by the surviving corporation pursuant to this subdivision (d) of the merger agreement consists of 4,522 shares of preferred stock of Federal Water Service Corporation of the $6 series, 5,610 shares of the $6.50 series and 1,466 shares of the $7 series.

Upon being informed by the staff of the Securities and Exchange Commission in April, 1941, that in its opinion the persons who are now interveners should execute agreements obligating them to hold the preferred stock purchased by them after November 8, 1937, for a reasonable time so that such stock would not be sold in the market, the intervener executed agreements in form satisfactory to the staff of the Commission, which provide that the intervener should hold such stock and should not sell the same until November 1, 1941, unless prior to that time the merger agreement should become effective or be abandoned. The agreements contain the express statements that they should not at any time be construed as or deemed an admission that such stock was in any way different from or entitled to any different or other rights than the preferred stock of the same series owned by any other holder and each agreement provides:

"3. That this instrument shall not be construed as a waiver of any right I may have to review in the man-
3985 ner provided by law any decision of the securities and Exchange Commission or to take such action as I may be advised to protect my rights as they may be established on such review."

The proceedings are now pending before the Commission on the plan of reorganization as so amended. A further hearing thereon was held August 12, 1941, and no final decision has been made.

7. The interveners are advised that the findings and opinion of the Commission of March 24, 1941, above described are erroneous, and that the preferred stock purchased by them should be treated in the reorganization on the same basis as preferred stock held by other stockholders. An argument to that effect was made by counsel for the corporations who are parties to these proceedings prior to the said findings and opinion of March 24, 1941, but after said findings and opinion were filed the corporations filed amendments to the proposed plan of reorganization, as set forth in Paragraph 6 hereof, and their counsel are now ad-

vocating the approval of the plan as so amended. At this time there is no one representing the interest of the interveners. The interveners are advised that they possess a legitimate interest which is inadequately represented, within the meaning of Rule 17 of the Rules of Practice of the Commission, and they desire to intervene herein.

3986 At the hearing on August 12, 1941, C. T. Chenery appeared as President of the Chenery Corporation, and W. A. Culin, F. T. Tansill and H. M. Erskine appeared personally. Mr. Chenery then stated that he had made arrangements for a lawyer to appear on his behalf and on behalf of the other persons referred to in Paragraph Fourth (d) of the proposed merger agreement, who are the present interveners, in order that they might object to that paragraph, ask for a rehearing with respect to the propriety of that paragraph, and if necessary have any order of the Commission approving the paragraph reviewed in the manner provided by the Act. Mr. Chenery stated that he had been informed on August 8, 1941, that the lawyer in question could not appear because of a possible conflict of interest, and that there had not been sufficient time before the hearing to obtain other counsel. Mr. Chenery stated that as President of Chenery Corporation he objected to Paragraph Fourth (d) of the proposed merger agreement and asked for reconsideration by the Commission and he requested that he be given an opportunity to retain counsel. Mr. Tansill, Mr. Culin and Mr. Erskine individually joined in Mr. Chenery's objection on behalf of the Chenery Corporation. The examiner then announced that the case would be kept open until August 16, 1941, in order to allow the Chenery Corporation and other preferred stockhold-

3987 ers in the same class to file a petition for intervention and a petition for rehearing. Thereafter on August 12, 1941, said preferred stockholders retained the firm of Covington, Burling, Rublee, Acheson & Shorb, of Washington, D. C., who theretofore had taken no part in the proceedings and who had no knowledge of the facts involved.

8. The interveners object to the approval of any plan of reorganization containing a provision similar to that of Paragraph Fourth (d) of the proposed merger agreement set forth in Paragraph 6 hereof, or in accordance with the opinion of the Commission expressed March 24, 1941, to the effect that the preferred stock purchased by the interveners should be treated on a less favorable basis than other preferred stock. They respectfully represent that the entry of an order approving a plan containing such a discriminatory provision would be unfair, inequitable, and detrimental to the interests of investors and would be erroneous and illegal. These interveners state that they have duly reported to the Commission all purchases of the preferred stock in question while they were directors or officers of the corporations in question. They state that Section 17 of the Public Utility Holding Company Act of 1935 provides that directors and officers shall report to the Commission their purchases of stock in registered holding companies
3988 and shall account for profits on sales made within six months of the purchase thereof, but such Act contains no prohibition of the purchase of stock by officers or directors and imposes no liability in regard to stock purchased and held for more than six months. They are advised and therefore allege that no principle of common or statutory law or equity forbids directors or officers of a corporation from purchasing stock therein, whether or not an application contemplating reorganization is under submission to the Securities and Exchange Commission.

Wherefore the interveners pray:

1. That this application to intervene be allowed, and that the interveners be made parties to the above entitled proceeding.

2. That counsel for the interveners be allowed a reasonable time to file briefs in support of the contentions made by the interveners herein and that oral argument thereon be allowed before the Commission, but no request is made for leave to take additional testimony.

3. That the case be reconsidered by the Commission to the extent that the present holding treats stock held by these applicants on a different basis from other preferred stock.

3989 4. That the Commission enter findings and opinion to the effect that the plan should be modified so that these interveners shall be treated in the same manner as other holders of preferred stock, and that the Commission deny effectiveness to the declarations herein unless they are so modified.

5. And for such other and further relief as may be appropriate.

Respectfully submitted,

COVINGTON, BURLING, RUBLEE,
ACHESON & SHORB,
Union Trust Building, Washington, D. C.,
Attorneys for
Chenery Corporation, H. M. Erskine, R. H. Neilson, W. A. Culin, F. T. Tansill, H. D. McHenry, T. H. Wiggin, C. M. Chenery, H. N. Greene, H. G. Calder, C. P. Rather, Wm. E. Matthews III, C. van den Berg, Jr., W. R. Edwards, Watson Dark, E. C. Deal, F. R. Harris, and E. C. Elliott.

SPENCER GORDON,
WM. MERRICK PARKER,
Union Trust Building,
Washington, D. C.,
Of Counsel.

3990 District of Columbia: ss.

W. A. Culin being duly sworn says that he is one of the interveners and that he makes this affidavit in his own behalf, as a preferred stockholder in Federal Water Service Corporation, and on behalf of the other preferred stockholders thereof who are named as interveners in the application for leave to intervene to which this affidavit is attached. He makes this affidavit on behalf of the other interveners because they are absent from the District of Columbia.

The interest of the interveners arises by reason of the fact that the merger agreement as now proposed contemplates the sale to Federal Water Service Corporation of certain preferred stock held by the interveners therein, all as more fully set forth in the application for leave to intervene to which this affidavit is attached. The position which this affiant and the other interveners propose to take with respect to the pending matter has heretofore been taken by the corporations, but at the present time said corporations are taking a position which is adverse to the interests of this affiant and the other interveners all as more fully set forth in said application for leave to intervene and there is no one in the case representing the interveners.

3991 This affiant, W. A. Culin, has read the application for leave to intervene to which this affidavit is attached, he states that he verily believes that the facts stated in said application are true and he makes said application a part of this affidavit without repeating the same herein.

W. A. CULIN.

Subscribed and sworn to before me this 15th day of August, 1941.

MARJORY E. WOOD,
Notary Public, D. C.

My commission expires July 15, 1944.

Order Granting Application to Intervene.

(filed August 18, 1941)

3992 United States of America

Before the Securities and Exchange Commission

At a regular session of the Securities and Exchange Commission, held at its office in the City of Washington, D. C., on the 18th day of August, A. D. 1941.

In the Matter of

FEDERAL WATER SERVICE CORPORATION
UTILITY OPERATORS COMPANY
FEDERAL WATER AND GAS CORPORATION

File Nos. 34-9
34-41
70-28

(Public Utility Holding Company Act of 1935)

Chenery Corporation, H. M. Erskine, R. H. Neilson, W. A. Culin, F. T. Tansill, H. D. McHenry, T. H. Wiggin, C. M. Chenery, J. N. Greene, H. G. Calder, C. P. Rather, William E. Matthews, III, C. van den Berg, Jr., W. R. Edwards, Watson Dark, E. C. Deal, F. R. Harris, and E. C. Elliott having on August 15, 1941, filed an application to intervene and become parties to the above entitled proceeding;

It appearing from said application that said applicants do not desire to take additional testimony but wish to file briefs in support of their contentions and make oral argument thereon;

It is ordered that subject to all of the proceedings heretofore had said applicants be and hereby are permitted to intervene and become parties to the proceeding; and

It is further ordered that said intervenors have leave to file briefs in support of their contentions provided the same shall be filed on or before August 28, 1941; and

It is further ordered that leave to make oral argument be and hereby is denied, subject, however, to such further or-

der, if any, as the Commission shall deem it appropriate to make in that regard after consideration of said briefs.

By the Commission.

FRANCIS P. BRASSOR,
Secretary.

. . . . . .

Report of the Commission on a Plan of Reorganization.

(September 24, 1941)

4000 Securities and Exchange Commission

Washington

In the Matter of

FEDERAL WATER SERVICE CORPORATION
UTILITY OPERATORS COMPANY
FEDERAL WATER AND GAS CORPORATION

File Nos. 34- 9
34-41
70-28

(Public Utility Holding Company Act of 1935)

This is a report of the Securities and Exchange Commission on a plan for the reorganization, or readjustment and simplification of the capital structure of, Federal Water Service Corporation (hereinafter referred to as "Federal"). The company's letter refers to a merger of certain affiliated companies into Federal. This is primarily a matter of legal mechanics and we will describe the transaction as one for the reorganization of Federal.[1]

This report is made because the Public Utility Holding Company Act requires that such a report be supplied in order to assist stockholders in determining whether to vote for or against the plan. Stockholders are urged to carefully consider the report and the other material furnished them. Under the laws of Delaware the approval of the holders of two-thirds of the outstanding stock is necessary before the plan can be consummated.

[1] In connection with the reorganization the name is to be changed to "Federal Water and Gas Corporation."

Reasons for Effecting a Reorganization of Federal

The existing corporate structure of Federal is complicated and highly unrealistic. The aggregate dividend requirements of the preferred stock and the Class A stock are far in excess of the company's ability to earn, and large arrearages of dividends on both the preferred and Class A stocks exist. Although the company is presently earning enough to meet a portion of the dividend requirements on the preferred stock, it is not lawful, under Delaware law, to pay any dividends by reason of the extent to which the capital of the company is impaired. Voting power, sufficient for practical purposes to control the company, is vested in the class B stock which, from the standpoint of both assets and earnings, is utterly worthless. The plan is designed to correct this unsatisfactory condition.

4001 *The Present Capitalization of Federal*

Federal's outstanding securities consist of debentures, preferred stock, Class A stock and Class B stock. The preferred stock is divided into several series having dividend preferences of $7, $6.50, $6 and $4, respectively. The $7, $6.50 and $6 series have voluntary liquidation preferences of $110 per share and involuntary liquidation preferences of $100 per share. The $4 series has voluntary and involuntary liquidation preferences of $68.75 and $62.50, respectively. The Class A stock is in the nature of a second preferred stock: it is junior to the preferred stock of all series both as to dividends and as to the distribution of assets upon liquidation; but it is superior to the Class B stock as to the distribution of assets and it has dividend preferences over the Class B stock plus participation with that stock in any additional earnings. The Class B stock has no preference of any kind but holds the sole voting power of the company unless, as is now the case, there are dividends in arrears on preferred or Class A stocks. Even now the Class B stock has 42.73% of the voting power.

Scope of the Plan

The plan of reorganization does not affect the outstanding debentures of Federal. It substitutes a single class of common stock for the various existing stocks of Federal.

It is especially appropriate for the reorganized corporation to have no class of stock other than common, for not only does the company have debentures outstanding but the greater part of its assets consist of common stocks of subsidiary companies. The common stock of the subsidiaries is subject to the prior claims of debt and preferred stocks of the subsidiaries. This new common stock is to be divided among the existing holders of the preferred and Class A stocks of Federal. The Class B stock is to be cancelled and no new securities issued to the Class B stockholders. The Commission concluded that this was fair since from the standpoint of both assets and earnings the Class B stock is utterly worthless.

Approximately 94% of the new common stock, which as we have seen will be the only class of stock outstanding, is in effect allocated by the plan to the holders of the preferred stock[2] and will be distributed among them upon the basis of the dividend preferences of the several series—the holder of a share of $7 preferred receiving seven shares of new common, the holder of a share of $6.50 preferred receiving six and one-half shares of new common, and so forth. The present ratios among the several series as to participation in earnings will thus be preserved by the plan. The present ratios among the several series as to participation in assets in the event of liquida-

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[2] Some shares of preferred stock held by the management receive less favorable treatment as explained in the latter portion of this report.

Holders of stock of Utility Operators Company are to receive 4.21% of the new common. Since this allocation is based primarily upon Utility Operators Company's ownership of 6,536 shares of Federal's preferred stock it is treated as an allocation to a preferred stockholder, and the 4.21% is included in the 94% referred to in the text of this report. A minor part of the allocation of new common stock to the holders of stock of Utility Operators Company is predicated upon that company's ownership of $2,000 principal amount of Federal's debentures and about $600 worth of miscellaneous assets.

tion, which as we have seen vary from the dividend preference ratios, are being disregarded.

The Class A stockholders will receive the balance (approximately 6%) of the new common stock, the holder of one share of Class A stock receiving 1/10 of a share of new common stock.

Fairness of the Plan to Preferred and Class A Stockholders

The fairness of the allocation of the new common stock as between the preferred stock, on the one hand, and the Class A stock, on the other hand, is dependent upon the position of the Class A stock with respect to the earnings and assets of the company. If the proposed plan had been consummated on June 30, 1941, the net assets of the reorganized corporation would have been valued upon its books at approximately $20,700,000. As against this amount, which represents the management's opinion of the fair value of the net assets on June 30, 1941, Federal has outstanding debentures in the principal amount of approximately $5,200,000 and on June 30, 1941 Federal's preferred stockholders had prior claims totaling approximately $25,600,000.[3] It is apparent that asset values would have to increase by approximately $10,100,000 for any assets to be available for the Class A stock in the event of a dissolution.

With regard to earnings it should be noted that numerous changes have taken place in the past in the holding company system of Federal on account of disposals and acquisitions of property, and it seems likely that such changes will occur in the future. The record of past earnings is therefore less reliable as an indication of what the future in fact holds than is often the case. It is nevertheless apparent that any hopes for dividends on the Class A stock must be limited to some time in the very remote future.

The following table shows the corporate net income of

[3] This amount is computed on the basis of the involuntary liquidating preferences and the arrearages of dividends.

Federal and the consolidated net income of the entire Federal system, including its subsidiaries, as reported for the years 1935 to 1940 inclusive, and for the twelve months ended June 30, 1941:

	Net Income	
Year	Corporate	Consolidated
1935	$(237,629)	$ 491,494
1936	292,952	1,033,165
1937	419,794	1,166,945
1938	446,470	987,763*
1939	425,155	1,498,046
1940	377,595	1,706,066
Year ended June 30, 1941	507,352	1,997,032

( ) Denotes loss.

* Consolidated net income for 1938 would have been $1,214,089 had it not been for an extraordinary deduction of $226,326 representing cost and expenses of natural gas exploration by Southern Natural Gas Company, a subsidiary.

4003 It will be noted that the corporate earnings shown in the table are substantially less than the $1,001,096 annual dividend requirements of the preferred stock. Although the average of the consolidated earnings for the six years 1935 to 1940 inclusive amounts to $146,150 more than the annual dividend requirements of the preferred stock, and although the consolidated earnings for the year ended June 30, 1941 was $995,936 in excess of such requirements, this does not indicate any possibility of dividends on the Class A stock in the near future. The dividend arrearages on the preferred stock, all of which would have to be paid before anything could be paid on the Class A stock, amounted to $9,760,686 on June 30, 1941. Also, the consolidated net income for the year ended June 30, 1941, shown on the above table at $1,997.032, would have been $345,000 less except for certain reductions in Federal income and excess profits taxes which were of a non-recurring nature. Moreover, because of various restrictions upon the payment of dividends by certain of the subsidiaries, Federal apparently could not realize $365,240 of the consolidated net income for the year ended June 30, 1941. Furthermore, seldom if ever can all of the earnings of subsidiaries be taken up by a parent corporation. Construction and

other requirements of the subsidiaries and restrictions imposed by regulatory bodies often make necessary the retention by them of part of their earnings.

It is thus apparent that no dividends could be paid on the Class A stock for many years. However, a majority of the Commission, believing that this stock had a reasonable prospect of benefiting at some remote future time from its existing rights in the corporation, held that it was entitled to participate in the reorganization and found that the present plan was fair and equitable in allocating approximately 6% of the new common stock to the old Class A stock. One of the Commissioners dissented from this conclusion and expressed the opinion that the preferred stockholders of Federal should have received the entire issue of new common stock.

Under the plan about 11,600 shares of preferred stock by officers and directors of Federal and Utility Operators Company during the pendency of reorganization are treated differently from the other shares of preferred stock. The Commission felt that because of the circumstances under which the shares were purchased, these holders could not equitably be permitted to realize any benefit by their acquisition. The plan accordingly provides that these shares will be purchased for cancellation by the reorganized corporation at cost, which amounts to about $285,000, plus 4% interest from the dates of acquisition by the present holders to the date of the merger. The company's letter states that an appeal is anticipated as to this feature of the plan and that it is believed that if the Commission's decision is reversed, the preferred stock held by the management should be permitted to participate in the reorganization on the same basis as the other preferred stock.

4004

Procedure to Make Plan Effective.

As we have previously noted, the laws of Delaware require that the plan be approved by the holders of two-thirds of the outstanding stock. Stockholders who make

objection in writing to the plan, and, furthermore, within twenty days after the merger make written demand, are entitled to have their stock purchased by the surviving corporation. Any stockholder deciding to follow this course should inform himself of the provisions of Section 61 of the General Corporation Law of Delaware in that regard, and carefully follow the procedure there prescribed. Under the proposed plan the directors of Utility Operators Company and Federal have the right to abandon the plan if stockholders holding 3,000 or more shares of Federal's preferred stock duly object to the merger at or prior to stockholders meetings at which the merger agreement is submitted to a vote.

Requirement of Holding Company Act.

The existing stock structure of Federal Water Service Corporation is repugnant to the standards of Section 11 of the Public Utility Holding Company Act. Unless voluntarily brought into compliance with the Act, it would be the duty of the Commission to institute a proceeding to require such action. In the opinion of the Commission the proposed plan would bring the stock structure of Federal into conformity with the standards of Section 11. A majority of the Commission considers the proposed plan fair to all concerned and has entered an order which will permit its consummation prior to November 1, 1941, if it is approved by the stockholders.

More Detailed Information on Plan Available.

This report has stated briefly only the important effects of the plan. In the interest of simplicity some features have not been discussed. The plan is dealt with in more detail in Holding Company Act Releases Nos. 2635 and 3023, being the Commission's Findings and Opinion (including the dissenting opinion referred to above), and Supplemental Findings and Opinion in this matter. Copies of these releases may be obtained by request made to the Sec-

retary of the Commission, 1778 Pennsylvania Avenue, N. W., Washington, D. C.

By the Commission.

FRANCIS P. BRASSOR,
(Seal) *Secretary.*

September 24, 1941.

Supplemental Findings and Opinion of the Commission.

(September 24, 1941)

4085 Securities and Exchange Commission

Washington

In the Matter of

FEDERAL WATER SERVICE CORPORATION
UTILITY OPERATORS COMPANY
FEDERAL WATER AND GAS CORPORATION

File Nos. 34-9
34-41
70-28

(Public Utility Holding Company Act of 1935)

In our Findings and Opinion herein[1] we pointed out the respects in which we deemed the plan of reorganization, which is the subject of this proceeding, repugnant to the standards of the Holding Company Act. However, we withheld entry of an order so that amendments might be filed revising the plan. Subsequently, further proceedings have been had, amendments have been filed and certain additional evidence has been received.

Th persons affected by that portion of the original opinion entitled "Preferred Stock Purchases by Directors and Officers" applied for leave to intervene and become parties to the proceeding. Their application was granted and they have filed briefs herein. They also asked leave to argue

[1] Holding Company Act Release No. 2935.

orally, and in our order of August 18, 1941 granting intervention we denied leave to make oral argument, subject, however, to such further order as we should deem it appropriate to make in that regard. Earlier in the proceeding we heard oral argument and considered contentions set forth in a brief by counsel for Federal Water Service Corporation. After careful consideration of the briefs filed by counsel for the intervenors we are satisfied no useful purpose would be served by oral argument thereon.

The additional evidence which has been received includes financial data of more recent date than some used in our original opinion. The following table shows the condensed balance sheets of Federal Water Service Corporation and Utility Operators Company and a pro forma balance sheet of the reorganized company as of June 30, 1941, giving effect to the proposed merger:

4006

TABLE I

Assets and Other Debits	Federal Water Service Corp.	Utility Operators Company	Pro Forma Reorganized Company
Investments	$27,751,394	$689,463	$19,210,420
Special funds	1,636,763 [2]	.....	1,636,763
Current Assets:			
Cash	926,807	863	315,330
Other	13,107	18	13,098
Consultation on capital stock	1,444,221	.....	.....
Organization expense	424,733	.....	.....
Office furniture and fixtures	26,851	.....	26,851
	$32,223,876	$690,344	$21,402,462
Liabilities, Capital and Surplus			
5½% Debentures due 1954	$ 5,222,000	.....	$ 5,220,000
Current liabilities	371,071	270	371,313
Deferred credits to income	44,228	.....	44,228
Reserves:			
Possible losses in investments	370,396	.....	.....
Miscellaneous	390,963	.....	390,963
Capital stock	31,336,373	282,144	4,921,655
Capital surplus	(3,847,290)	409,967	10,554,303
Earned surplus	(1,883,865)	(2,037)	.....
	$32,223,876	$690,344	$21,402,462

( ) Denotes deficit.

[2] This item includes $1,397,525 which represents deposits to guarantee purchase of common stock of Southern Natural Gas Company not subscribed for by holders of warrants prior to September 15, 1941.

It should be noted that while certain investments will be written up in the aggregate by about $2,700,000, the net write-down will be in excess of $8,500,000. Substantially all of the increase results from an increase in the amount at which the investment in Southern Natural Gas Company is to be carried. The amount at which Federal proposes to carry this investment is less than its market value, its unlerlying book value and the amount at which shares of this stock were recently sold on subscription, and appears reasonable on the basis of capitalized earnings. Under the particular circumstances of this readjustment in which there is also a substantial change in proprietorship interests, it does not seem improper to us for the reorganized company to recognize, in the course of a net write down, increases as well as decreases in investment values, if as here there appears sufficient reason to believe that such increases in value are real and not fictitious.

In order to insure that future profits or losses from sales of investments of Federal, based on the amounts stated in reorganization, do not improperly affect the payment of dividends by the company, we shall condition our order so as to require, with respect to any sales of these investments within three years, that profits be credited to capital surplus and that losses be charged to income or earned surplus unless upon application the Commission shall approve some other disposition.

We also believe that the capital surplus which will be created in the reorganization, amounting to approximately $10,500,000 should not be used to absorb losses arising from subsequent operations. We shall therefore reserve jurisdiction to regulate charges made to this capital surplus.

4007 Since our original opinion Utility Operators Company has disposed of $1,000 principal amount of its holdings in Federal's debentures and has used the proceeds for expenses. As a result, the stockholders of Utility Operators Company will receive 83 less shares of the common stock of the surviving corporation. This fact, together with

the treatment which the plan now accords to the preferred stock purchased by officers and directors since November 8, 1937, has necessitated certain minor changes in the total amount of the new common stock which will be issued and in the percentage of stock which will be issued to the various classes of stockholders of Federal. The following table shows the proposed distribution of the new common stock:

TABLE II

	Present Stocks	Rate of Exchange	New Common Stock	
Federal Water Service Corporation:				
Preferred (Held by Public):				
$7.00 Series	12,889	7 for 1	90,223	
$6.50 Series	62,030	6½ for 1	403,195	
$6.00 Series	63,868	6 for 1	383,208	
$4.00 Series	2,348	4 for 1	9,392	
	141,135		886,018	90.01%
Class A	568,775	1/10 for 1	56,877	5.78%
Utility Operators Company:				
Common Stock	56,428.9	.7343 for 1	41,436	4.21%
Total New Common Shares			984,331	100.00%

We think that the above allocation among security holders is fair under the reasoning of our original opinion. The financial aspects of the new securities, as indicated by the amendments, meet the requirements set forth therein. The par value of the 1,500,000 authorized shares of common stock of the surviving corporation has been reduced from $12 to $5, so that now no adverse findings are required under Section 7 (d) (1) and 7 (d) (2) of the Act. The provisions for a "staggered" board of directors which, under the circumstances of this case, would have resulted in an unfair distribution of voting power, have been eliminated. The plan now contemplates that the incumbent directors shall remain in office only until a special stockholders' meeting is held at which time the new stockholders will have the opportunity to vote on the election of a new board, and that such meeting shall be called within ninety days following the reorganization.

The revised plan also denies equal participation to the preferred stock of Federal Water Service Corporation pur-

chased by C. T. Chenery,[3] and others, since Novem-
4008 ber 8, 1937. It is now provided that the surviving corporation shall purchase this stock at its cost to the management plus 4% interest from the dates of purchase by the management to the date of the merger. The intervenors have filed a brief asking that we enter findings and an opinion to the effect that the plan should be modified so that they shall be treated in the same manner as other holders of preferred stock and that we deny effectiveness to the declaration unless it is so modified. After consideration of the brief we adhere to the views expressed in our original opinion.

It appearing that some of the shares of stock purchased by these officers and directors have been sold, arrangements have been made to secure to the corporation the profits realized on these sales. These arrangements take the form of agreements entered into between officers and directors and the corporation. They are so worded as to expire on November 1, 1941, and we must, therefore, issue our order subject to the condition that the merger be effected prior to that date.

Declarants state that the fees and expenses in connection with the proposed plan will be approximately $90,318.14,[4] itemized as follows: attorneys' fees and expenses, $44,270.38; valuation reports, $13,531.29; auditor's fees, $986.80; printing, $3,000; postage, $7,000; engraving new stock certificates, $3,000; fees of transfer agents and registrars, $10,500; advertising and miscellaneous, $8,029.67. In view of the fact that this case has been pending for over four years, during which time many proposed plans of reorganization have been submitted and many conferences and hearings have been held, the amounts do not appear to be unreasonable or excessive and will be approved.

The revised plan of reorganization seems to meet the requirements of Section 7 of the Act set out in our original

[3] Including Chenery Corporation, wholly owned by C. T. Chenery and members of his family.

[4] If the new common stock is listed on the New York Stock Exchange, listing fees will be approximately $12,000 additional.

opinion. The solicitation material which has now been filed with us is satisfactory.

The applications will be granted and the declarations will be permitted to become effective subject, however, to the following conditions:

(1) That the proposed merger agreement be adopted and the reorganization and merger effected prior to November 1, 1941.

(2) That within ten days of the consummation of the reorganization and merger the applicants and declarants shall certify to the Commission that the transactions have been carried out in accordance with the terms and conditions of and for the purposes represented by the applications and declarations now on file with the Commission.

(3) That profits from sales, within three years, of investments held by the reorganized corporation upon completion of the reorganization be credited to capital surplus and that losses be charged to income or earned surplus unless upon application the Commission shall approve some other disposition of such profits and losses.

4009 (4) That no charge shall be made to capital surplus unless (a) such charge has previously been authorized by appropriate resolution of declarant's board of directors, and (b) subsequent to such resolution of the board of directors, thirty days prior notice of the making of such charge be given to this Commission. The Commission reserves jurisdiction, on receipt of such notice, in and as part of the proceedings herein, after notice given within such thirty days and opportunity for hearing, to disapprove such charge on the basis of the record herein and any additional evidence that may be adduced by any interested party; and in the event that the Commission shall notify declarant to show cause why such charge should not be disapproved, the charge in question shall not be made until expressly authorized by order of this Commission.

(5) That the Commission reserves jurisdiction to entertain, at the request of the applicants and declarants or any of them, such further proceedings and such further action

as may be appropriate regarding any step which may be taken to consummate the proposed reorganization and merger.

An appropriate order will issue

By the Commission (Chairman Eicher and Commissioners Pike and Burke), Commissioner Healy filing a dissenting statement (see below) and Commissioner Purcell being absent and not participating.

/s/ FRANCIS P. BRASSOR,

(Seal) *Secretary.*

4010 Healy, C., dissenting.

The Report, which we have today issued to security holders pursuant to Section 11 (g) of the Act, states on page 3: "It is apparent that asset values would have to be increased by approximately $10,100,000 for any assets to be available regard to earnings, the Report states, on page 3: "It is for the Class A stock in the event of dissolution." With nevertheless apparent that any hopes for dividends on the Class A stock must be limited to some time in the very remote future." Furthermore, it should be noted that it was found necessary under the majority opinion of March 24, 1941[1] to reduce the par value of the 1,500,000 authorized shares of common stock of the surviving corporation from $12 to $5.

The pro forma balance sheet shows net assets at about $20,700,000. Deducting from this the outstanding debentures of $5,220,000, leaves about $15,480,000 with which to satisfy preferred stock claims of approximately $25,600,000, a deficiency of approximately $10,120,000. There can be no pretense that the common stock to be issued in exchange for the old preferred will have, within any reasonable future period of time, a market value of anything like approximately $25,600,000.

All of this to my mind demonstrates, as I tried to demonstrate in my dissent of March 24, 1941,[2] that there is no

[1] Holding Company Act Release No. 2635.

[2] *Id.*

basis here, under applicable principles which I believe have been established by the courts, for the participation of the Class A stock.

Certified to be Commissioner Healy's dissenting statement herein.

/s/ FRANCIS P. BRASSOR,
Secretary.

Order Permitting Declarations to Become Effective and Granting Applications.

4011 United States of America

Before the Securities and Exchange Commission

At a regular session of the Securities and Exchange Commission, held at its office in the City of Washington, D. C., on the 24th day of September, A. D., 1941.

In the Matter of

Federal Water Service Corporation
Utility Operators Company
Federal Water and Gas Corporation

File Nos. 34-9
34-41
70-28

(Public Utility Holding Company Act of 1935)

Federal Water Service Corporation, Utility Operators Company and Federal Water and Gas Corporation having filed applications and declarations, and amendments thereto, pursuant to the Public Utility Holding Company Act of 1935 and the Rules and Regulations promulgated thereunder with respect to a plan for the readjustment and simplification of the capital structure of Federal Water Service Corporation by means of and in connection with a merger between said corporations; and

A public hearing having been held after appropriate notice, and the Commission having considered the record and

having made and filed its findings and opinion and its supplemental findings and opinion herein;

It Is Hereby Ordered that said applications, as amended, be and the same hereby are granted forthwith, and that said declarations, as amended, be and the same hereby are permitted to become effective forthwith, subject, however, to the following conditions:

(1) That the proposed merger agreement be adopted and the reorganization and merger effected prior to November 1, 1941.

(2) That within ten days after the consummation of the reorganization and merger the applicants and declarants shall certify to the Commission that the transactions have been carried out in accordance with the terms and conditions of and for the purposes represented by the applications and declarations now on file with the Commission.

(3) That profits from sales, within three years, of
4012 investments held by the reorganized corporation upon completion of the reorganization be credited to capital surplus and that losses from such sales be charged to income or earned surplus unless upon application the Commission shall approve some other disposition of such profits and losses.

(4) That no charge shall be made to capital surplus unless (a) such charge has previously been authorized by appropriate resolution of declarant's board of directors, and (b) subsequent to such resolution of the board of directors, thirty days prior notice of the making of such charge be given to this Commission. The Commission reserves jurisdiction, on receipt of such notice, in and as part of the proceedings herein, after notice given within such thirty days and opportunity for hearing, to disapprove such charge on the basis of the record herein and any additional evidence that may be adduced by any interested party; and in the event that the Commission shall notify declarant to show cause why such charge should not be disapproved, the charge in question shall not be made until expressly authorized by order of this Commission.

(5) That the Commission reserves jurisdiction to entertain, at the request of the applicants and declarants or any of them, such further proceedings and such further action as may be appropriate regarding any step which may be taken to consummate the proposed reorganization and merger.

By the Commission.

/s/ FRANCIS P. BRASSOR,

(Seal) *Secretary.*

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EXCERPTS FROM DOCUMENT 158

Findings and Opinion of the Commission

In the Matter of FEDERAL WATER SERVICE CORPORATION, UTILITY OPERATORS COMPANY, FEDERAL WATER AND GAS CORPORATION, File Nos. 34-0, 34-41, 70-28, (Public Utility Holding Company Act of 1935)

* * * * *

The applications and declaration [1] underlying this case have as their primary objective the reorganization of Federal Water Service Corporation (hereinafter called "Federal") pursuant to a plan of merger proposed by its management. The contemplated reorganization is to be effectuated by a merger of Utility Operators Company, the parent of Federal, and Federal Water and Gas Corporation, a wholly owned subsidiary of Federal, into Federal.[2] Utility Operators Company and Federal are registered holding companies. All three corporations are organized under the laws of Delaware.

Utility Operators Company, the top company of what is commonly known as the Federal Water Service system, is solely a holding company. Its only assets are all of the outstanding shares of Federal's Class B common stock, 6,536 shares of the same company's preferred stock, $3,000 principal amount of its debentures, and about $600 worth of miscella-

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[1] Federal Water Service Corporation has filed (File No. 34-0) an application pursuant to Rule U-12E-4, for a report on a plan for its reorganization, and a declaration pursuant to Rule U-12E-5, with respect to solicitation of consents to this plan. Utility Operators Company has filed (File No. 34-41) a similar application and declaration. Federal Water Service Corporation and Utility Operators Company have jointly filed (File No. 70-28) a declaration pursuant to Section 7 with respect to the alteration of rights of their security holders and the issuance of new securities incident to the proposed merger. Federal Water and Gas Corporation has filed (File No. 34-0) a declaration pursuant to Section 7 with respect to alteration of rights of the holder of its securities incident to the proposed merger. This declaration adopts the application and declaration filed by Federal Water Service Corporation and Utility Operators Company and asks that Federal Water and Gas Corporation be made a party thereto.

[2] Federal Water Service Corporation, the surviving corporation, will change its name to Federal Water and Gas Corporation (the name now borne by its subsidiary).

neous assets. Its only outstanding securities are shares of common stock, all owned by officers, directors, and present and former employees of Federal. The company owes no debt.

Federal Water and Gas Corporation has never actively engaged in any business, and its assets are unimportant. All of its outstanding securities, ten shares of common stock of the par value of $100, are owned by Federal. Although not required to register under the Act, Federal Water and Gas Corporation is subject to it in certain respects as a subsidiary of a registered holding company.

Financial condition of Federal Water Service Corporation

Federal is solely a holding company controlling many subsidiaries which operate water, gas, electric, and other properties in thirteen states and in one foreign country. The following is a table of its outstanding securities: [1]

Type of Security:		Amount
5½% Gold Debentures due 1964		$5,222,000
Preferred stocks (stated value*)		
$7.00 series, 15,296 shares	$1,529,600	
Arrearages	980,416	
$6.50 series, 60,888 shares	6,080,282	
Arrearages	4,202,016	
$6.00 series, 71,706 shares	6,812,070	
Arrearages	3,979,083	
$4.00 series, 2,370 shares	148,068	
Arrearages	88,625	
Total preferred stocks		24,449,778

*Involuntary liquidating value is $100 per share plus accrued dividends for all classes of preferred except the $4 series which has an involuntary liquidating value of $62.50 per share plus accrued dividends. Voluntary liquidating value is $110 per share plus accrued dividends for all classes of preferred except the $4 series which has a voluntary liquidating preference of $68.75 per share plus accrued dividends.

Type of Security:		Amount
Class A Stocks**, 569,775 shares (exclusive of 1,420 held in the treasury)	$13,606,733	
Arrearages	10,617,133	
		$24,283,866
Class B stock, 542,430 shares		2,500,400
		56,455,044

**In the event of liquidation the Class A stock is entitled to receive, subject to the prior rights of the preferred stock, $50 per share plus accumulated dividends, and thereafter to share equally with the Class B stock in any remaining assets.

[1] Here, as throughout, unless otherwise stated, figures are as of December 31, 1940.

On the balance sheet of Federal Water Service Corporation of December 31, 1939, total assets are stated at $29,915,729, but the investments owned by the corporation are carried at $23,836,361, a figure which the management itself regards as excessive. There are in addition intangible assets which it is proposed to write off in the reorganization.

With total assets stated at an admittedly high figure, there is nevertheless a capital surplus deficit of $3,848,865. In addition, there is a deficit in earned surplus account of $3,865,070. These deficits, totalling $7,713,935, have provided the primary incentive to reorganization, for so long as they impair the capital represented by stock having a preference on the distribution of assets, the payment of dividends on any class of stock will be illegal under Delaware law.*

There are other factors. The heavy arrearages on the preferred and Class A stocks and the revision in stated value of assets are two others that have already been adverted to. Finally, there are the requirements of Section 11 (b) (2) of the Public Utility Holding Company Act of 1935.

Under this section, it is the duty of the Commission to require, among other things, that each registered holding company and its subsidiaries take such steps as the Commission shall find necessary to insure that their corporate structures do not unfairly or inequitably distribute voting power among security holders. No elaborate demonstration is necessary to establish that the distribution of voting power in Federal violates the statutory standard. Normally, the entire voting power of the company is vested in the Class B stock, but because of dividend arrearages on the preferred and Class A, these stocks have now acquired a majority of the voting rights. The 42.73% of total voting power which still rests in the hand of the B stockholders is clearly unfair and inequitable in view of the fact that the capital deficit entirely wipes out the book value of the Class B stock, and that it has no actual value whatsoever, as we shall show below.

It is also the duty of the Commission, under Section 11 (b) (2), to require each registered holding company to take steps

*General Corporation Law of Delaware, Section 34 (1935).

to insure that its corporate structure does not unduly or unnecessarily complicate the structure of the holding company system. The deficits in both capital surplus and earned surplus accounts of Federal, its inability to pay dividends even on its stocks having prior rights, and its large arrearages, provide a combination of complexities which clearly falls within the scope of this section of the Act. For this reason as well its existing distribution of voting power, Federal was confronted with the prospect of compulsory simplification under Section 11 (b) (2) unless it could succeed in thoroughly revamping its structure by some other permissible method.

Prior attempts to effectuate reorganization

The management has recognized the need for reorganization for several years. Even before Federal registered under the Act, discussion between its representatives and members of the Commission's staff had begun, and when Federal registered on November 8, 1937, it immediately filed a plan for reorganization under Section 7 of the Act. The plan now before us is the fourth to be filed by the company, the three previous plans all having been withdrawn, in each case after hearing had been held thereon before a Trial Examiner of the Commission. With respect to none of the earlier plans have there been findings and opinions of the Commission. The record indicates, however, that one of the principal obstacles to the earlier consummation of a reorganization was the issue of allocation of new securities to the Class B stockholders. Each of the plans prior to the present one provided for participation in the equity of the reorganized company by the Class B stockholders (either immediately or upon the exercise of purchase warrants for additional stock).

The present plan, the first to involve the merger of Utility Operators Company and Federal Water and Gas Corporation with Federal, was filed on March 30, 1940. The application states that the merger device was used in view of a recent decision of the Supreme Court of Delaware in *Havender* v. *Federal United Corporation*,[5] which established the propriety

[5] 11 A. 2d 331 (Del. 1940)

under Delaware law of directly affecting accrued dividends on preferred stocks in a merger, in contrast to the position taken by the Delaware courts with respect to similar action by charter amendment.[6]

After due notice hearings were held on the applications and declarations herein before a trial examiner of the Commission. Tentative findings and opinion were prepared by the Commission (in which Commissioner Healy did not participate) and distributed to the parties. Thereafter, counsel to Federal and counsel to the Commission filed briefs and were heard in oral argument before the Commission.

Outline of Present Plan.—As already pointed out, Utility Operators Company and Federal Water and Gas Corporation are to be merged into Federal.[7]

The proposed participation by present holders of securities

The debentures of Federal Water Service Corporation are to remain undisturbed by the plan except for a small change in amount.[8] The present stockholders of Federal Water Service Corporation and the common stockholders of Utility Operators Company[10] are to receive new common stock, which the declaration states will have a par value of $12 per share, as indicated in the following table:

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[6] Cf. *Keller* v. *Wilson & Co.*, 190 A. 115 (Del. 1936); *Consolidated Film Industries, Inc.* v. *Johnson*, 197 Atl. 489 (Del. 1937).

[7] William S. Fox and Louis Russo, representing themselves and other holders of Class A stock appeared and were heard. A brief was filed by counsel to Mr. Russo.

[8] Upon consummation of the merger, Federal Water Service Corporation is to change its name to Federal Water and Gas Corporation.

[9] The face amount of debentures outstanding of the reorganized corporation will be $5,259,000 instead of $5,262,000. (These figures should be reduced by $40,000 for debentures purchased in 1940.) $3,000 of debentures now owned by Utility Operators Company will be cancelled.

[10] The ten outstanding shares of Federal Water and Gas common, all owned by Federal, are to be cancelled; so are the 1,420 shares of its own Class A which Federal holds in its treasury; so, too, are all of the shares of Federal of all classes held by Utility Operators Company (including all of the Class B stock, entirely owned by Utility Operators Co.).

	Shares to be Converted	New Common			
		Shares		Par Value (at $12 per Share)	Percent
		Rate	Number		
Federal Water Service Corporation:					
$7.00 Preferred	14,355	7	100,485	$1,205,820	9.50
$6.50 Preferred	67,640	6½	439,660	5,275,920	41.54
$6.00 Preferred	68,390	6	410,340	4,924,080	38.77
$4.00 Preferred	2,348	4	9,392	112,704	.89
Total Preferred	152,733		939,877	$11,518,524	90.70
Class A	568,775	1/10	56,877	682,524	5.38
Utility Operators Company: Common	56,428 9/10	*.7357	41,514	498,168	3.92
			1,038,268	$12,699,216	100.00

*This ratio is explained immediately below in the text.

None of the new common stock allocated to Utility Operators is allotted in recognition of its own stock or its ownership of all of Federal's Class B stock, which it is to surrender for cancellation. The 5.38% of new common allocated to the present holders of the new common stock is based almost [11] entirely upon its holdings of 6,536 shares of Federal preferred and the application of the same conversion rates, set forth in the above table, which were applied to other holdings of preferred. Hence, except for the 5.3% of new common allocated to the present holders of Class A stock, substantially all of the equity of the reorganized company will be given to the present preferred stockholders.

The declaration states that the new stock is to have a par value of $12 per share, and that 1,500,000 shares are to be authorized, of which it is contemplated that 1,058,268 will be issued, as shown in the above table.[12]

Under the plan the intangible items, "commission on capital stock" and "organization expense," which are presently carried

[11] 300 shares of the new common represent consideration for the $3,000 in debentures of Federal, which are being cancelled, and $600 of other assets.

[12] Section 61 of the General Corporation Law of Delaware provides that a stockholder who objects to a merger and complies with applicable statutory provisions may receive the value of his stock from the surviving corporation. To the extent that this privilege is exercised in the present case the number of shares of new common to be issued will be reduced. If holders of 3,000 or more shares of Federal Preferred, irrespective of series, object to the merger, the boards of directors of both Federal and Utility Operators Company reserve the right to abandon the proposed plan.

or, the books at $1,444,221.16 and $424,732.50, respectively, will be written off the books, and the assets of the surviving corporation will be recorded on the books at their reasonable value as determined by the board as of the date of the merger,[13] and such capital surplus as the recorded value of assets permits will be recorded. The following table shows the balance sheets of Federal Water Service Corporation and Utility Operators Company as at December 31, 1939, and a pro forma balance sheet of the surviving company as of the same date,[14] giving effect to the merger:

	Federal Water Service Corporation	Utility Operators Company	Pro Forma* Federal Water and Gas Corporation (surviving company)
ASSETS			
Investments	$24,406,757	$187	$17,607,808
Less—Reserve	570,396		
Net investments	23,836,361	187	17,607,808
Investment in Federal		690,320	
Special Funds	262,238		262,238
Current assets:			
Cash	3,660,437	1,012	3,661,449
Other	258,023	28	258,022
Commission on capital stock	1,444,221		
Organization expense	424,733		
Office furniture and fixtures	29,716		29,716
Total assets	29,915,729	691,547	21,819,233
LIABILITIES			
5½% unsecured debentures	5,262,000		5,259,000
Current liabilities	502,967	428	503,367
Miscellaneous reserves	508,323		508,327
Capital stock:			
Preferred	13,189,640		
Class A	13,666,734		
Class B	2,500,000		
Common		282,145	12,699,216
Capital surplus	(3,848,865)	429,967	2,849,327
Earned surplus	(3,865,070)	(993)	
Total liabilities	29,915,729	691,547	21,819,233

*Assuming no holders of stock now outstanding will avail themselves of statutory provisions entitling objecting stockholders to require purchase of their shares.

[13] A write-down of approximately six million dollars in the value of investments is contemplated.

[14] The record is not complete enough to present this comparison as of December 31, 1940.

The plan also provides that the present directors of Federal Water Service Corporation shall be the first directors of the surviving corporation, and that the election of new directors shall be "staggered" as follows: of the seven present directors, two shall remain in office until the next annual meeting of stockholders following the effective date of the merger agreement; two others, for one year thereafter; and the remaining three, for two years thereafter. The present board was chosen by the Class B stockholders. Under the proposed arrangement, the holders of new common will not be able to elect a majority of directors for approximately two years, control in the meantime continuing in the remaining members of the present board.

Applicable Provisions of the Act.—The plan involves the alteration of priorities, preferences, and voting power, and has been presented to us by a declaration under Section 7 of the Holding Company Act.[15] In the first instance, the major questions before us center in the standards of Section 7.

* * * * *

We do not disagree with conclusion in Commissioner Healy's dissent that the standard "detrimental to the interests of investors" contained in the above sections is not identical with the standard of "fair and equitable" contained in Section 11 (e). Nor do we disagree that the plan before us must be considered in the light of the standards of section 11 (e). In reaching this conclusion, we are motivated by two factors:

(a) We have held that the test "detrimental to the interest of investors" involves a consideration of the question whether the terms of the proposed plan are within the permissible limits of bargaining indicated by the rights and priorities of the various classes of security holders. *International Paper & Power Co.*, S. E. C. 580, 582–583 (1937) (reversed on other

[15] Section 6 (a): "Except in accordance with a declaration effective under section 7 and with the order under such section permitting such declaration to become effective, it shall be unlawful for any registered holding company or subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly (1) to issue or sell any security of such company; or (2) to exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of such company."

grounds, *Lawless* v. *Securities and Exchange Commission*, 105 F. (2d) 574 (C. C. A. 1st, 1939)). We think that we cannot determine whether the proposed plan is within the permissible limits of bargaining for the different classes of security holders without consideration of what the position of these classes would be if we entered an order under Section 11 (b) (2).[16]

(b) It is apparent that one of the purposes of the proposals is to bring the Federal Water Service system into compliance with standards of Section 11 (b) (2). This plan is, in effect, the type of plan for which Congress made provision in Section 11 (e) of the Act—that is, "a plan * * * for the divestment of control, securities, or other assets, or for other action by such company * * * for the purpose of enabling such company * * * to comply with the provisions of subsection (b)." We think it plain, therefore, that we should consider this plan in the light of the standards imposed by the Act for plans presented under Section 11 (e), namely, that the plan be "necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan."

As we shall now proceed to show, our conclusion is the same whether we treat the plan under the standards of Sections 7 (d) (6) and 7 (e) or under the standards of Section 11 (e). For that reason we need not consider whether we should, in effect, give retroactive application to our Form U–1 (adopted February 2, 1940, long after Federal filed its declaration) which states that: "If an application states the facts which make applicable a particular provision of the Act of rules and the record is adequate to determine the questions arising under such provision, the Commission may grant an appropriate order notwithstanding the failure of the application to specify such provision * * *." Nor, in view of this conclusion, need we consider whether Federal should be given further opportunity to present evidence bearing on issues presented by a plan tendered under Section 11 (e).

* * * * *

[16] See *supra*.

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Preferred Stock Purchases by Directors and Officers.—A further question as to the fairness of the plan arises with respect to the participation to be accorded to preferred stock held by members of the management of Federal. The plan of reorganization herein considered, like previous plans filed with us over the past several years, was formulated by the management of Federal, and discussions concerning the reorganization of this corporation have taken place between the management and the staff of the Commission over the past several years. C. T. Chenery, president of the debtor, and a corporation owned by his family purchased 8,618 shares of Federal preferred stock between November 8, 1937, when the first plan was filed with us, and June 30, 1940. These purchases were made on the over-the-counter market through brokers at prices ranging from 16½ to 34 for the $6.00 preferred. Very few of the shares were bought at prices higher than 30 and a substantial portion of them was purchased at prices in the low 20's. Other officers and directors of Federal and of Utility Operators Company acquired 3,789 shares during the same period at prices at the same general level.

The following table shows the purchases made between November 8, 1937, and June 30, 1940, the amount paid and the book value of the new common shares for which this preferred would be exchanged:

	$7.00	$6.50	$6.00	Total	Cost	No. of Common Shares	Book Value of the Common to be Received in Merger
C. T. Chenery	1,211	3,847	3,560	8,618	$240,148.01	54,692	$803,972.40
Other Officers and Directors of Federal Utility Operators Company	255	2,793	741	3,789	88,198.88	24,385	358,459.50
	1,466	6,340	4,601	12,407	$328,346.89	79,077	$1,162,431.90

Under the proposed plan, the preferred shares so purchased would participate in the plan on a parity with all other shares of preferred stock of the same series. We have come to the conclusion that this feature of the plan cannot be approved.

In reaching this conclusion, we have not failed to take into

consideration the fact that after individual stockholders had made complaint of the management's purchases, the officers and directors agreed upon a policy of deferring individual purchases while particular plans were in contemplation but had not been made public. An honest effort appears to have been made to adhere to this policy.

But we do not think that this fact was enough. Corporate directors are fiduciaries—their powers are powers in trust. *Pepper* v. *Litton*, 308 U. S. 295. We hold further that in the process of formulation of a "voluntary" reorganization plan, the management of a corporation occupies a fiduciary position toward all of the security holders to be affected, and that it is subjected to the same standards as other fiduciaries with respect to dealing with the property which is the subject matter of the trust. Of course, the management does not hold title to the securities, but its duty of fair dealing with the persons for whom it acts is as great as is that of a trustee who holds title to a *res* for the benefit of his beneficiaries." A trustee may not "become the purchaser of the property which he represents or any portion of it though he has done so for a fair price without fraud at a public sale." *Michoud* v. *Girod*, 4 How. 502, 557 (1846). Accordingly, honesty, full disclosure and purchase at a fair price do not take the case outside the rule. The need for an inflexible rule was recognized in *Michoud* v. *Girod*, *supra*:

> Is it not better that the cause of the evil shall be prohibited, than that courts of equity shall be relied upon to apply the remedy in particular cases, by inquiring into all the circumstances of a case, whether there has or has not been fraud in fact? (At 557.)

" In re *Standard Commercial Tobacco Co., Inc.*, 34 F. Supp. 304, 310 (S. D. N. Y. 1940) and cases cited. Compare Berle and Means, *The Modern Corporation and Private Property* 1 (1932) c. VII, *Corporate Powers as Powers in Trust*. Compare also sec. 16 (b) of the Securities and Exchange Act of 1934 and sec. 17 (b) of the Public Utility Holding Company Act of 1935, which recognize the fiduciary character of the management—officers, directors, and principal stockholders—and its opportunity to use inside information, by providing that any profits made on purchases and sales, or sales and purchase, within six months should inure to the benefit of the corporation.

Or, as the Supreme Court later stated in *Magruder* v. *Drury*, 235 U. S. 106, 119, 120 (1914):

> The rule in such cases springs from his duty to protect the interests of the estate, and not to permit his personal interest to in any wise conflict with his duty in that respect. The intention is to provide against any possible selfish interest exercising an influence which can interfere with the faithful discharge of the duty which is owing in a fiduciary capacity. * * * It makes no difference that the estate was not a loser in the transaction or that the commission was no more than the services were reasonably worth.

In *Meinhard* v. *Salmon*, 249 N. Y. 458, Chief Justice Cardozo said:

> Many forms of conduct, permissible in a work-a-day world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morale of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this, there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

These principles have been applied to persons whose fiduciary position arises from the fact that they act for others in the formulation of a reorganization plan. The principles have been codified in Section 249 of the Bankruptcy Act, but the application of the principle does not depend on the existence of a statute. It depends on the broad equitable principles enunciated in the cases heretofore cited. See *Woods* v. *City National Bank & Trust Co. of Chicago*, Supreme Court of the United States, decided February 3, 1941. Indeed, Section 249 of the Bankruptcy Act is merely declaratory of the position taken by the federal courts under Section 77B of the Bankruptcy Act as applied to dealings by reorganization committee members in the securities of the corporation being reorganized. See *In the Matter of Mountain States Power Co.* (C. C. A. 3d, March 5, 1941), *aff'g* 35 Supp. 307 (D. Del. 1940); *Otis & Co.* v. *Insurance Bldg. Corp.*, 110 F. (2d) 333 (C. C. A. 1st 1940); *In re Paramount-Publix Corporation*, 12 F. Supp. 823, 828 (S. D. N. Y. 1935) cited with approval in *American United Mutual L. Ins. Co.* v. *City of Avon Park, Florida*, 61 S. Ct. 157, decided Nov.

25, 1940; *In re Republic Gas Corporation*, 35 F. Supp. 300 (S.D. N.Y. 1936). The result of these cases does not depend on dishonesty or unfair dealing for it was conceded in the *Otis* case, *supra*, that the brokerage house which acted as committee had lost money in the transactions, that it had acted in good faith, that the sellers of the bonds knew that the house was representing the bondholders, and that it had entered into the transactions "for the accommodation" of its customers. Similar facts appeared in the *Mountain States* case. In the *Republic* case Judge Caffey said:

> Because of the inconsistent positions which are an unavoidable incident, it is a fraud in law for a trustee to purchase property which is the subject matter of his trust and the making of such a purchase is misconduct.
>
> * * * * *
>
> There is no blinking the fact that the ground on which the court denounces as a fraud the purchase by a trustee of trust property is that it inevitably brings about conflict of interest between himself personally and the beneficiaries of his trust; or at least that it incites a motive, *or affords opportunity for a motive*, on the part of the trustee to take advantage of his superior knowledge acquired in his trust capacity, which may induce him to conceal his information from the beneficiaries or not to employ it exclusively for their benefit, while they are relying on him scrupulously to devote himself to the furtherance of their welfare (*Michoud* v. *Girod*, *supra*, pp. 554, 555, 559).
>
> * * * * *
>
> I believe that only by rigid enforcement of that duty can the continuance or reinstatement of old evils, which were of general knowledge, be prevented or, if prevention prove impossible, be minimized.
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> * * * * *
>
> Furthermore, if, as I deem it established, the misconduct amounts to a fraud in law, I conceive of no good reason why the penalty for the fraud should not be denial of any compensation whatever for those services. Indeed, I feel that the only available device for promoting, if not assuring, justice to depositing bondholders in the management of their affairs, and thus of restoring or attempting to restore faith in deposit agreements, is strict application to committeemen of the ancient equity rules governing the conduct of trustees, including deprivation of compensation where there is a departure from those rules.
>
> * * * * *
>
> It may well be that there are some who, without veering away from the utmost faithfulness, could safely be left free to trade in bonds which are the subject matter of their trusts. Nevertheless, the danger of the contrary is so manifest, the bondholders themselves generally are so helpless and the hurt to them is or may be so serious that; in order to protect against the evil, or the possibility of the evil, from which bondholders have suffered so grievously in the past, and which Congress intended to bring to an end,

the court should inflexibly enforce the rule that members of committees shall not trade in the securities with respect to which they are acting or undertaking to act in behalf of the owners.

We think that the authorities heretofore cited are fully applicable to the position of the management of a corporation trading in the securities which will be affected by a voluntary plan of reorganization upon which the management is working. We, no more than a court of equity, should undertake to decide case by case whether the management's trading has in fact operated to the detriment of the persons whom it represents. As the Supreme Court said in *Woods* v. *City National Bank & Trust Co. of Chicago*, *supra*:

> • • • It is no answer to say that fraud or unfairness were not shown to have resulted.' Cf. *Jackson* v. *Smith*, 254 U. S. 586, 589. The principle enunciated by Chief Justice Taft in a case involving a contract to split fees in violation of the bankruptcy rules, is apposite here: "What is struck at in the refusal to enforce contracts of this kind is not only actual evil results but their tendency to evil in other cases." *Weil* v. *Neary*, 278 U. S. 160, 173. • • •

• • • • •

The remedies to be applied in particular cases may be chosen with utmost flexibility. In the *Otis & Company*, *Mountain States Power*, *Paramount-Publix* and *Republic Gas* cases, *supra*, the questions arose on the applications of fiduciaries for fees and in all cases the fees were disallowed.[10] In this case no application for fees is presented to us, but other remedies may be appropriate. As Mr. Justice Douglas said in *American United Mutual Life Insurance Company* v. *City of Avon Park, Florida* (61 S. Ct. 157), decided November 25, 1940:

> • • • Where such investigation discloses the existence of unfair dealing, a breach of fiduciary obligations, profiting from a trust, special

[10] This treatment demonstrates that no attempt is made to apportion the remedy to the injury done, but the standard of fiduciary conduct is enforced by denying *all* opportunity for profit to fiduciaries who trade in the securities with respect to which they have the fiduciary duty. Compare section 16 (b) of the Securities Exchange Act of 1934 and section 17 (b) of the Public Utility Holding Company Act of 1935, which, for the purpose of preventing the unfair use of inside information by directors, officers, and other insiders, provide that any profit made by them on purchases and sales, or sales and purchases, within six months, shall inure to the benefit of the corporation, regardless of the existence of overreaching or the amount thereof in the particular case.

benefits for the reorganizers, or the need for protection of investors against an inside few or of one class of investors from the encroachment of another, the court has ample power to adjust the remedy to meet the need. The requirement of full, unequivocal disclosure; the limitation of the rate to the amount paid for the securities (*In re McEwen's Laundry, Inc.*, 90 F. (2d) 872); the separate classification of claimants (see *First National Bank v. Poland Assn.*, 109 F. (2d) 34, 35); the complete subordination of main claim (*Taylor v. Standard Gas & Electric Co.*, 306 U. S. 307; *Pepper v. Litton*, supra), indicate the range and type of the power which a court of bankruptcy may exercise in these proceedings. That power is ample for the emergencies of varying situations. *It is not dependent on express statutory provisions.* It inheres in the jurisdiction of a court of bankruptcy. The necessity for its exercise (*Pepper v. Litton*, supra, p. 308) is based on the responsibility of the court before entering an order of confirmation to be satisfied that the plan in its practical inclusive embodies a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle * * *. (Italics supplied.)

Similarly, deciding whether the terms of issuance of the new common stock are fair and equitable or are detrimental to the interests of investors, we must find that they are unfair, inequitable, and detrimental so long as the preferred stock purchased by the management at low prices is to be permitted to share on a parity with other preferred stock. In this respect this case closely resembles the *Avon Park* case itself. That case involved a municipal composition under Chapter IX of the Bankruptcy Act. R. E. Crummer & Co., the city's fiscal agent, purchased obligations of the city at about 50 cents on the dollar, both before and after execution of the fiscal agency contract. In holding that the plan had been improperly confirmed, the Supreme Court ruled not only that all of the benefit to be obtained by the fiscal agent from the securities purchased had to be considered in determining whether its aggregate compensation was reasonable, but also that any excess benefits accruing to the fiscal agent would make the plan unfair and inequitable because it would discriminate in his favor as a creditor. See also *In re Norcor Mfg. Co.*, 109 F. (2d) 407 (C. C. A. 7th, 1940); *In re McCrory Stores Corp.*, 12 F. Supp. 267 (S. D. N. Y. 1935).[10]

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[10] Compare sec. 57B (b) of the Bankruptcy Act, which provides that "the judge * * * may limit any claims filed by such committee member or agent, to the actual consideration paid therefor" and sec. 212 of Chapter X of the Bankruptcy Act, which provides that "the

We believe that a formula should be devised which will limit the participation of the preferred stock purchased by the management to an amount which takes into account the purchase prices paid, plus accumulated dividends since the dates of the respective purchases. We do not now attempt to indicate what that formula should be, since the matter is complicated by the fact that the apportionment of stock among the several series of preferred stocks is to be based upon their respective dividend rates and dividend accumulations rather than upon their liquidation values. Our staff will be available for consultation with Federal with respect to this matter and we shall give further consideration to this question if and when Federal files amendments to its proposal.

For the present we deny effectiveness to these declarations because we must enter adverse findings under sections 7 (d) (1) and 7 (d) (2) so long as the par value of the proposed common stock is fixed as high as $12 per share; because we find that the provisions with respect to the board of directors of the surviving company would result in an unfair distribution of voting power; and because we find that the provisions for participation by the preferred stock held by the management

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Judge * * * may limit any claim or stock acquired by any such person or committee in contemplation of or in the course of the proceeding under this chapter to the actual consideration paid therefor." We do not read the *Avon Park* case or the other cases cited as holding that in no case may a claimant receive parity treatment for securities purchased at a discount during the reorganization. Such parity treatment is the usual rule. *Security-First National Bank of Los Angeles* v. *Rindge Land & Navigation Co.*, 85 F. (2d) 531 (C. C. A. 9th, 1936), rehrg. denied, 86 F. (2d) 3, certiorari denied, 299 U. S. 613, rhrg. denied, 300 U. S. 686; *Texas Hotel Securities Corporation* v. *Waco Development Co.*, 87 F. (2d) 396 (C. C. A. 5th) certiorari denied, 300 U. S. 670, rehrg. denied, 301 U. S. 713; *In re Utilities Power & Light Corporation*, 29 F. Supp. 765, 770 (N. D. Ill.), app. dism., C. C. A. 7th on March 9, 1940; *In re Radio-Keith-Orpheum Corporation*, 106 F. (2d) 22, 27 (C. C. A. 2d). Cf. *In re Tennessee Publishing Co.*, 81 F. (2d) 663, 666 (C. C. A. 6th); aff'd, 299 U. S. 18; *Cromwell* v. *County of Sac*, 96 U. S. 51, 60; and *Wade* v. *Chicago, Springfield & St. Louis R. R. Co.*, 140 U. S. 327, 343. We think the principle involved in the *Avon Park* case is limited to purchase during reorganization in violation of fiduciary duty. Compare the provisions of sec. 77B (b) and sec. 212 of the Bankruptcy Act, *supra*, which are limited to persons acting in a fiduciary capacity.

result in the terms of issuance of the new securities being detrimental to the interests of investors and the plan being unfair and inequitable. We shall withhold entry of an order refusing to permit the declarations to become effective for a period of 30 days. If during that time Federal files amendments to its proposal designed to cure the defects in its plan which we have pointed out, we shall give further consideration to the matter. If within such time amendments are not filed, we shall enter an order refusing to permit the declarations to become effective.

By the Commission: (Chairman Frank and Commissioners Eicher and Pike), Commissioner Healy dissenting (see separate opinion below), and Commissioner Henderson being absent and not participating.

Separate opinion of Commissioner Healy.

* * * * *

I

The first question for decision is: Under what section of the Act shall we judge the plan, Section 7 (e) or Section 11 (e)?

* * * * *

No one contends that this plan must be tested by the standards of Section 7 (e) merely because the management of Federal affixed the label of that section to the plan. It is axiomatic that the management of a corporation cannot by its choice of labels foreclose the security holders' right to have the plan judged by the appropriate standards of the Act and to enjoy whatever protection is afforded them thereunder.*

* It is noteworthy that the present Form U-1 (which has supplemented Form U-7 on which Federal filed its application) states that: "If an application states the facts which make applicable a particular provision of the Act or rules and the record is adequate to determine the questions arising under such provision, the Commission may grant an appropriate order notwithstanding the failure of the application to specify such provision * * *."

II

. . . . . .

I have concluded that the plan of reorganization should be tested by the standards of Section 11 (e).

. . . . . .

C. Having concluded that "fair and equitable," as used in Section 11 (e) means what it regularly means in reorganization law, I pass to the question: Is this plan "fair and equitable"? That question has to be answered, however feasible the plan may be, however "necessary" or "appropriate" it may be to effectuate the purposes of Section 11 (b). It is a question of law. I think it should be answered in the negative.

(1) The proposal that preferred stock, obtained by the management while they were in essence the reorganization managers in charge of this plan, be permitted to participate exactly as other preferred stock seems against equity and good conscience. The impropriety of permitting them to participate on such a basis in the circumstances of this case has ample support. Cf. *Pepper* v. *Litton*, 308 U. S. 295; *Taylor* v. *Standard Gas Co.*, 306 U. S. 307.

. . . . . .

U S GOVERNMENT PRINTING OFFICE 1942

IN THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

No. 8074

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., PETITIONERS

against

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

Petition of Federal Water and Gas Corporation for leave to intervene, to file a brief, and to participate in oral argument

To the United States Court of Appeals for the District of Columbia:

The petition of Federal Water and Gas Corporation respectfully represents:

I. The above-entitled cause has been brought in this Court as an original proceeding under the authority of Section 24 (a) of the Public Utility Holding Company Act of 1935 by the above-named petitioners, stockholders of Federal Water Service Corporation, to review an order of the Securities and Exchange Commission (hereinafter called the "Commission") filed on September 24, 1941, in certain proceedings entitled "In the Matter of Federal Water Service Corporation, Utility Operators Company, Federal Water and Gas Corporation, File Nos. 34-9, 34-41, 70-28 (Public Utility Holding Company Act of 1935)."

II. Federal Water and Gas Corporation, petitioner herein for intervention (hereinafter referred to as "Federal") is a Delaware corporation organized in 1926 under the name, Federal Water Service Corporation, and is one of the corporations which filed Applications and Declarations with the Commission in said proceedings before the Commission, upon which the order of the Commission of September 24, 1941, was issued.

III. Federal is interested in the above-entitled proceedings in this Court for the following reasons:

(a) On March 30, 1940, Federal and two other Delaware corporations, Utility Operators Company and Federal Water and Gas Corporation, filed Declarations with the Securities and Exchange Commission under Section 7 of the Holding Company Act of 1935 and Applications for a Report upon a Plan of Reorganization of Federal to be accomplished by merger under Section 59 of the Delaware Corporation Law of Utility Operators Company and Federal Water and Gas Corporation into Federal which, by the merger agreement,

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was to assume the name of Federal Water and Gas Corporation. By the proposed merger agreement filed with the Commission on March 30, 1940, each stockholder of Federal, owning shares of Federal of any class, was treated the same as any other stockholder of Federal owning shares of the same class.

(b) On March 24, 1941, the Securities and Exchange Commission filed formal findings and opinion in the said proceeding in which it was held that such plan could not be approved insofar as it provided for participation of preferred shares purchased by officers or directors of Federal or Utility Operators Company or by Chenery Corporation after November 8, 1937, on a parity with other shares of preferred stock of the same class. In order to obtain an order of the Securities and Exchange Commission permitting the merger agreement to become effective and obtain a report from the Securities and Exchange Commission permitting a plan to be submitted to stockholders, Federal, Utility Operators Company, and Federal Water and Gas Corporation amended the merger agreement so as to comply with the findings and opinion of the Commission of March 24, 1941, as interpreted by the staff of the Commission. Such amended merger agreement contained a paragraph, Fourth (d), reading as follows:

"No shares of common stock of the surviving corporation shall be issued in lieu of the shares of preferred stock of Federal Water Service Corporation purchased since November 8, 1937, by Chenery Corporation, or since November 8, 1937, by the following persons when they were officers or directors of Federal Water Service Corporation or Utility Operators Company and which are owned by them on the effective date of the merger agreement: J. N. Greene, W. R. Edwards, C. M. Chenery, H. G. Calder, C. P. Rather, R. H. Neilson, Wm. E. Matthews III, Watson Dark, E. C. Deal, H. M. Erskine, F. T. Tansill, F. R. Harris, W. A. Culin, H. D. McHenry, T. H. Wiggin, E. C. Elliott, and C. van den Berg, Jr. Each such holder shall be entitled to receive and the surviving corporation shall be obligated to pay, upon the surrender of the certificates of such stock to the surviving corporation, the actual cost of such stock to such holder, together with interest thereon at four percent per annum from the dates of its or his purchase of such stock to the effective date of the merger agreement. In ascertaining cost of preferred stock acquired by exchange of other securities for purposes of this provision, the fair market value at the date of exchange of the securities given in exchange shall be deemed to be the cost of such preferred stock. In the event any shares of preferred stock of Federal Water Service Corporation purchased by Chenery Corporation or by the said officers or directors of Federal Water Service Corporation or Utility Operators Company since November 8, 1937, shall have been sold by such corporation or individual prior to the effective date of the merger agreement, the surviving corporation shall, upon the surrender of the remaining such shares owned by such corporation or individual, be obligated to pay to such corporation or individual a sum equal to the actual cost of all

preferred stock of Federal Water Service Corporation purchased by it or him since November 8, 1937, together with interest thereon at four percent per annum from the dates of its or his purchase of such stock to the effective date of the merger agreement minus the proceeds of the sale by it or him of any such shares together with interest thereon at four percent per annum from the dates of its or his sale of such stock to the effective date of the merger agreement. The shares of preferred stock to be acquired by the surviving corporation pursuant to this subdivision (d) of the merger agreement consist of 4,522 shares of preferred stock of Federal Water Service Corporation of the $6 series, 5,610 shares of the $6.50 series and 1,466 shares of the $7 series."

(c) On August 15, 1941, Chenery Corporation and the other persons named in paragraph Fourth (d) of the merger agreement filed an application with the Commission for leave to intervene in the proceedings before the Commission and object to the approval by the Commission of the merger agreement insofar as it included paragraph Fourth (d). Said application for intervention was granted and said persons became parties to the proceeding before the Commission and, pursuant to leave granted, filed a brief in support of their objections to paragraph Fourth (d) of the merger agreement. On September 24, 1941, their objections to paragraph Fourth (d) of the merger agreement were overruled by the Commission and the Commission granted its order permitting the Declarations of Federal, Utility Operators Company, and Federal Water and Gas Corporation to become effective under Section 7 of the Holding Company Act of 1935 and issued its report on the Plan of Reorganization to be sent to stockholders.

(d) Meetings of the stockholders of Federal, Utility Operators Company, and Federal Water and Gas Corporation were duly held on October 28, 1941; the merger agreement was approved by the requisite vote of the stockholders of each of said corporations and on October 31, 1941, the merger agreement was filed in the office of the Secretary of State of Delaware and a certified copy thereof recorded in the office of the Recorder of Kent County, Delaware, and thereby became effective. Pursuant to the merger agreement stockholders of Federal and Utility Operators Company have surrendered their stock for stock of the surviving corporation and there are now outstanding certificates for upwards of 800,000 shares of common stock of the surviving corporation which have been issued in exchange for certificates of preferred stock and Class A stock of Federal and stock of Utility Operators Company.

(e) At the stockholders meeting of Federal on October 28, 1941, Chenery Corporation and the individual stockholders, petitioners in the above proceeding, voted their stock which was referred to in paragraph Fourth (d) of the merger agreement against the merger and accompanied their vote with letters in substantially the following form:

"FEDERAL WATER SERVICE CORPORATION,
"90 Broad Street, New York, N. Y.

"DEAR SIRS; I enclose herewith proxy for the shares of preferred stock of Federal Water Service Corporation owned by me which are treated by paragraph Fourth (d) of the merger agreement to be submitted to the stockholders at the meeting of October 28, 1941, differently from shares of preferred stock of the same class owned by others. I have checked the space on the proxy marked 'against.' Pursuant to the notice printed thereon, you are to regard this proxy as an objection in writing to the merger for purposes of Section 61 of the Corporation Law of the State of Delaware. I am taking this action in connection with the petition which I, as one of the interveners, have filed in the United States Court of Appeals for the District of Columbia to review the order of the Securities and Exchange Commission of September 24, 1941, and I hereby state with the intention that this statement should be relied upon by the Board of Directors of Federal Water Service Corporation in deciding whether to declare the merger agreement operative that

"(1) if, in the proceeding taken by the interveners to review the order of the Securities and Exchange Commission, it is finally determined that said order shall be affirmed, I will surrender my stock referred to in paragraph Fourth (d) of the merger agreement to the surviving corporation for cancellation for the consideration set forth in paragraph Fourth (d) of the merger agreement;

"(2) if, on the other hand, it should be finally determined in said proceeding that the said order of the Securities and Exchange Commission should be modified or set aside, I will accept stock of the surviving corporation in exchange for my stock referred to in this proxy as though the discriminatory and unlawful paragraph Fourth (d) were not contained in the merger agreement and/or in satisfaction of any rights which I may have to the value of said stock upon the same terms as stock of the surviving corporation has been offered for exchange to others, not included in paragraph Fourth (d) of the merger agreement.

"Very truly yours,"

Thereafter and within the time allowed by Section 61 of the Delaware Corporation Law said Chenery Corporation and each of the petitioners made demands upon Federal by letters in substantially the following form:

"FEDERAL WATER AND GAS CORPORATION,
"90 Broad Street, New York, N. Y.

"DEAR SIRS: This is to notify you that I contend that paragraph Fourth (d) of the agreement of merger between Federal Water Service Corporation, Utility Operators Company, and Federal Water and Gas Corporation is illegal and in violation of my rights as the holder of ------ shares of preferred stock of Federal Water Service Corporation which shares have been discriminated against by paragraph

fourth (d) of the agreement of merger and I demand that you issue o me shares of your common stock of the par value of $5 each in exhange for said shares of preferred stock upon the same terms and onditions as such common stock was offered to other holders of the ame class by paragraph Fourth (e) of the agreement of merger or n the alternative, I demand damages for the unlawful conversion of aid stock by said paragraph Fourth (d) of the agreement of merger, r in the alternative, I hereby demand payment for said stock purant to Section 61 of the General Corporation Law of the State of Delaware, all to the end that in the event the order of the Securities nd Exchange Commission insofar as it approved said paragraph ourth (d) of the said agreement of merger shall be modified or set side, I shall have all the rights in the premises to which I am legally ntitled.

"Very truly yours,"

IV. Federal is interested in the relief to which petitioners herein re entitled if it should be held that paragraph Fourth (d) of the erger agreement was in violation of the rights of petitioners as ockholders of Federal and believes that it should be made a party to is proceeding and that this Court should have jurisdiction over it. f said paragraph Fourth (d) of the merger agreement was not in ccordance with the legal rights of petitioners and they were legally ntitled to receive the same treatment by the reorganization plan as as accorded to other holders of stock of Federal of the same class, ederal desires to correct the error by the issuance of its shares of uthorized but unissued stock to the petitioners herein so that they ill receive such stock upon the same terms as stock was offered to ther stockholders of the same class by the merger agreement.

V. As a precedent for this petition, Federal cites *Lawless* v. *Securiies and Exchange Commission*, 105 F. (2d) 574, where International aper and Power Company was permitted to intervene in a proceedng brought by a stockholder to review an order of the Commission ranting an application of that company.

Wherefore, Federal prays that it be allowed to intervene in this roceeding and be made a party thereto, with leave to file a brief nd to participate in oral argument.

FEDERAL WATER AND GAS CORPORATION,
By ALLEN S. HUBBARD,
Attorney.

CHARLES E. HUGHES, JR.,
ALLEN S. HUBBARD,
Of Counsel.

TATE OF NEW YORK,
County of New York, ss.:

Allen S. Hubbard, being duly sworn, deposes and says: That he General Attorney for Federal Water and Gas Corporation and hat he is familiar with the matters referred to in the foregoing

petition and that he verily believes that the statements therein contained are true.

ALLEN S. HUBBARD.

Sworn to before me, this 6th day of January, 1942.

JAMES D. McCAULEY,
One Wall St., New York City.

Commission expires March 30, 1943.

Acknowledgment of service

January 7, 1942. Received a copy of petition of Federal Water and Gas Corporation for leave to intervene, to file a brief, and to participate in oral argument.

SECURITIES AND EXCHANGE COMMISSION,
By R. W. PATTERSON,
Ass't. Chief, Docket Section.

CHENERY CORPORATION,
H. M. ERSKINE,
R. H. NEILSON, ET AL.,
Petitioners,
By SPENCER GORDON,
Attorney.

United States Court of Appeals for the District of Columbia

January Term, 1942.

No. 8074.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.,
PETITIONERS
vs.
SECURITIES AND EXCHANGE COMMISSION

United States Court of Appeals for the District of Columbia. Filed Jan. 23, 1942. Joseph W. Stewart, Clerk.

On consideration of the petition of Federal Water and Gas Corporation for leave to intervene in the above entitled cause, and answers thereto, it is,

Ordered by the Court that said Federal Water and Gas Corporation be, and it is hereby, allowed to intervene only for the purpose of filing a brief; brief to be filed not later than February 4, 1942.

PER CURIAM.

Dated January 23, 1942.

Tuesday, February 10th, A. D. 1942

Before the Honorable D. Lawrence Groner, Chief Justice, and the Honorable Justin Miller and Fred M. Vinson, Associate Justices.

No. 8074

Chenery Corporation, H. M. Erskine, R. H. Neilson, et al., petitioners

vs.

Securities and Exchange Commission

The argument in the above-entitled cause was commenced by Mr. Spencer Gordon, attorney for petitioners, continued by Mr. Homer Kripke, attorney for respondent, and concluded by Mr. Spencer Gordon, attorney for petitioners.

United States Court of Appeals for the District of Columbia

No. 8074

Chenery Corporation, H. M. Erskine, R. H. Neilson, et al., petitioners,

v.

Securities and Exchange Commission, respondent; Federal Water and Gas Corporation, intervenor

On petition for review of order of Securities and Exchange Commission

(Argued February 10, 1942. Decided April 27, 1942)

Mr. Spencer Gordon, with whom Messrs. William Merrick Parker and William DuBose Sheldon were on the brief, for petitioners. Mr. Fontaine C. Bradley also entered an appearance for petitioners.

Mr. Homer Kripke, with whom Messrs. Chester T. Lane, General Counsel, Christopher M. Jenks, Assistant General Counsel, Lawrence S. Lesser, Special Counsel, and Frederick N. Jones were on the brief, all of the Securities and Exchange Commission, for respondent.

Messrs. Charles E. Hughes, Jr., and Allen S. Hubbard, by special leave of court, filed a brief on behalf of Federal Water and Gas Corporation, as Intervenor.

Before Groner, C. J., and Miller and Vinson, JJ.

Groner, C. J.: This is a petition to review an order of the Securities and Exchange Commission issued under the Public Utility Holding Company Act of 1935.[1] The order was made on an application filed with the Commission March 30, 1940, for approval of a plan

[1] Tit. 15, U. S. C. A., Sec. 79a, *et seq.*

of merger among Federal Water Service Corporation, Utility Operators Company, and Federal Water and Gas Corporation. Federal Water Service Corporation (hereinafter called Federal) is a Delaware corporation, and at the time of filing the application was the owner of securities of subsidiary water, gas, electric, and other properties. At the time in question, Federal had outstanding $5,222,000 of 5½ percent Gold Debentures due 1954, four series of approximately 160,000 shares of preferred stocks, a little more than half a million shares of Class A stock, and a like amount of Class B stock. Federal's balance sheet showed a capital deficit of approximately four million dollars, in consequence of which, under the laws of Delaware, the payment of dividends on any Class of stock was prohibited. Utility Operators Company (hereinafter called Utility) was a holding company owning all the outstanding shares of Federal's Class B common stock and some 6,500 shares of its preferred stock. Federal Water and Gas Corporation's assets were unimportant, and its entire outstanding stock was owned by Federal. In November, 1937, Federal registered with the Commission, and on the same day, filed an application pursuant to Section 7 of the Public Utility Holding Company Act of 1935 for a voluntary reorganization to be accomplished, pursuant to the Delaware law, through an amendment to its charter reducing its capital by a ratable reduction of the stated values of its several stock issues. The purpose was to eliminate its capital deficit and thus to enable it to resume payment of dividends on its preferred stocks. The Commission never formally acted on the application, nor on three other more or less similar plans proposed during the following three years, because, in the opinion of the Commission, Federal's capital was so reduced as to leave no equity for the Class B stock which, under the proposed plans, was to continue with large voting power. This the Commission thought was inequitable under Section 11 (b)(2) of the Act.[1]

In January, 1940, the Supreme Court of Delaware decided Havender v. Federal United Corporation, 11 A. 2d 331, the effect of which was to declare that under Delaware law preferred stock, together with dividends in arrears thereon, might be converted into new securities through a merger. Taking advantage of this opportunity for a rearrangement of its capital structure, Federal filed with the Commission, in March, 1940, a new application and declaration setting forth a plan of reorganization involving the merger of Utility and Federal Water and Gas into Federal. The former two filed declarations in accordance with the proposed merger.

During the period from November, 1937, when the first plan was filed, to June, 1940, some four months after the new plan was submitted, petitioners, who are officers and directors of Federal, and Chenery, a corporation owned by some of them, purchased approximately 12,000 shares of a total issue of approximately 160,000 shares

[1] The Section provides that the Commission may require the company to readjust its structure so as to fairly distribute the voting power of its securities.

of Federal's preferred stock. All of the purchases were currently reported to the Commission as required by Section 17 of the Act.[3]

The merger plan, which the Commission ultimately approved on conditions, contemplated the elimination of Class B stock and the conversion of the preferred stocks and Class A stock into new common stock with a new par value, the effect of which was to reduce materially the capital of the corporation. The condition to which we have just referred was that no shares of the new common stock should be issued in exchange for shares of preferred stock purchased in the three-year period, 1937–1940, by any officer or director of the corporation; but that the shares so purchased should be surrendered to the new corporation upon payment to the purchasers (petitioners) of the cost price and four percent interest from the date of purchase. The Commission imposed this condition because it was of the opinion that officers and directors of Federal occupied, during the whole pendency of proceedings before the Commission, a fiduciary relation to the corporation and to its shareholders, as the result of which the purchase of stock, even though made honestly and after full disclosure and at a fair price at a public sale, was detrimental to the "public interest." The Commission's report points out that under the proposed plan these shares would participate on a parity with other shares of preferred stock, and this the Commission thought ought not in the circumstances to be allowed. The Commission said that, while admittedly the directors did not hold title to the company's stock, they nevertheless owed a duty in dealings with the shareholders as great as "that of a trustee who holds title to a *res* for the benefit of his beneficiaries." On this theory, it concluded that, since a "trustee" may not become the purchaser of property which he holds in trust, neither may the officers or directors of a corporation, under any circumstances or conditions, purchase shares of stock pending Commission proceedings.

This brings us, then, to the question in the case, which is whether these purchases of stock, in the circumstances narrated, were "detrimental to the public interest or the interest of investors" within Section 7 of the Act.[4]

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[3] Sec. 17. (a) Every person who is an officer or director of a registered holding company shall file with the Commission in such form as the Commission shall prescribe (1) at the time of the registration of such holding company, or within ten days after such person becomes an officer or director, a statement of the securities of such registered holding company or any subsidiary company thereof of which he is, directly or indirectly, the beneficial owner, and (2) within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, a statement of such ownership as of the close of such calendar month and of the changes in such ownership that have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company or any subsidiary company thereof, any profit realized by any such officer or director from any purchase and sale, or any sale and purchase, of any security of such registered holding company or any subsidiary company thereof within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the holding company or subsidiary company in respect of the security of which such profit was realized, irrespective of any intention on the part of such officer or director in entering into such transaction to hold the security purchased or not to repurchase the security sold for a period of more than six months. * * *

[4] Public Utility Holding Company Act of 1935:

Sec. 6 * (a) Except in accordance with a declaration effective under section 7 and with the order under such section permitting such declaration to become effective, it shall be unlawful for any registered holding company or subsidiary company thereof, by use of

Preliminary to the discussion of this question, it may be helpful to relate briefly the conditions under which the stock was purchased. When the first plan was proposed, members of the Commission's staff objected to the retention of voting power in Federal by its Class B common stock, substantially all of which belonged to Utility Operators Company, which in turn was controlled by officers and directors of Federal. This opposition held in suspense for two and a half years the proposed plan and various subsequently suggested amendments. Notice of the Commission's position in this regard was made public both by the Commission and Federal, and it is agreed was known and understood by stockholders or investors. Realizing that if the Commission persisted in this stand the officers and employees of Federal who had invested in this class of stock would find themselves without either a stake or influence in the company they had helped create and by which they were employed, Chenery, president of Federal, suggested to many of them that they use what money they could spare to buy preferred stock, stating that he would follow the same course. This resulted in purchases over a period of two and a half to three years on the part of various officers and directors of the corporation. The average purchase of each of the 16 officers and directors, other than Chenery and one Vandenberg was around 130 shares. Chenery, for the account of a family corporation controlled by him, purchased approximately 8,000 shares, of which a lot of 2,700 shares was not a purchase but an exchange for $100,000 of Federal's prior debenture gold bonds, and as to which the other party to the transaction testified that he preferred to have the bonds to the stock, "and today I am very much delighted we made the trade." The remaining director, Vandenberg, who at the time of the merger—we gather from the record—had ceased to be an officer and director of the corporation, purchased in the open market approximately 1,700 shares.

The Commission's brief and argument in this court explicitly declare that the conclusion to outlaw this stock is not "predicated on any finding that petitioners defrauded or failed to make the fullest disclosure to the stockholders from whom they purchased the shares in question." On the contrary, the Commission, very properly, admits that the transactions complained of were consummated without "any ulterior purpose" and equally without any intention to profit personally "in the consummation of the plan through having traded while the proceedings were pending." We have, therefore, a

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the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly (1) to issue or sell any security of such company; or (2) to exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of such company.

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Sec. 7. (a) A registered holding company or subsidiary company thereof may file a declaration with the Commission, regarding any of the acts enumerated in subsection (a) of section 6.

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(d) If the requirements of subsections (c) and (g) are satisfied, the Commission shall permit a declaration regarding the issue or sale of a security to become effective unless the Commission finds that

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(6) the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers.

case in which the facts are agreed, the good faith of petitioners admitted, and the decision based squarely on the assumption that the purchase of securities of a corporation by its officers or directors for their own account, pending action on an application for approval of a merger, is "detrimental to the public interest" as that phrase is used in Section 7 (d)(6) of the Act. It is true that the Commission in its brief refers also to the standard "fair and equitable" applicable under Section 11 (e) of the Act; but if there is a substantial distinction in meaning or purpose between the phrase "detrimental to * * * the interest of investors or consumers" and the phrase, not "fair and equitable to the persons affected by such plan"—which we think is not the case—the fact is that the proceedings in the present case were conducted under Section 7 of the Act and the decision expressly rendered under that Section, though the Commission says its conclusion would be the same whether the application is considered under the standards of 7 or of 11. And to this may be added, that there is no finding that the acts of petitioners in this case are unfair or inequitable "to the persons affected" by the plan, but the contrary.

Obviously, therefore, the answer to our question must be found in the light of the standards the statute prescribes, as like or similar "standards" have been interpreted or explained by the courts. In this view, if we are brought to conclude that there was at the time no regulation of the Commission, no provision of the statute, and no rule of common law or equity prohibiting the purchase of stock by an officer or director of a corporation during the pendency of the proceedings we are concerned with; and if there is superadded to this a showing of honesty, good faith, and equal knowledge on the part of the sellers, of all the facts and circumstances having any relation to the transaction, all of which the Commission concedes, it would seem logically to follow that the action of the Commission in applying the rule it did was an erroneous assumption of power and an invasion of the legislative field. This brings us, then, to consider whether there is any statute, regulation, or rule of common law or equity which proscribes the present transactions.

There is no disputing the proposition that under the laws of Delaware the purchase of the shares of stock in a corporation by a director is entirely legal and proper. Caholl v. Lofland, 12 Del. Ch. 299, 114 A. 224; Dupont v. Dupont, 236 Fed. 129, cert. denied, 250 U. S. 642. This is also the rule in practically all of the other States. The great weight of authority is that a director is not the trustee of stockholders in dealing with one of them for the purchase of his stock, as the term "trustee" is ordinarily used. At most, the relationship is a circumstance which may enter into the question of actionable fraud or deceit.[1] The textwriters, too, all agree that the general rule is that,

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[1] Steinfeld v. Nielsen, 15 Ariz. 424, 139 Pac. 879; Bacon v. Soule, 19 Cal. App. 428, 126 Pac. 384; Hooker v. Midland Steel Company, 215 Ill. 444, 106 Am. St. Rep. 170, 74 N. E. 445; Tipperanee County v. Reynolds, 44 Ind. 509, 15 Am. Rep. 245; Waller v. Hodge, 214 Ky. 705, 283 S. W. 1047; Re Shreveport National Bank, 118 La. 664, 43 So. 270; Bigbee v. Hay, 209 Mass. 401, 169 N. E. 268; Walsh v. Goulden, 130 Mich. 531, 90 N. W. 691; Seitz v. Frey, 152 Minn. 170, 188 N. W. 266; Wann v. Scullin, 210 Mo. 429, 109

while directors occupy a trust relation to the corporation, the same relation does not exist as to stockholders—at least in the sale and purchase of their stock. Fletcher on Corporations, § 1168; Thompson on Corporations, § 1258; Cook, on Corporations, (4th Ed) 622; Taylor on Corporations, (5th Ed.) § 698; Beach on Corporations, §§ 246, 614. Indeed, so far as we are able to find, no case has gone to the length of holding a director accountable to a stockholder in the purchase and sale of shares of stock except where fraud or some form of overreaching is shown as the inducing cause of the transaction. Admittedly, there is no rule or regulation of the Commission on the subject, nor has the Commission ever before sought to enforce an order like the present one. No stronger proof of this can be instanced than the language of the Commission's March, 1941, report, where for the first time the right of the purchasers of the stock was questioned in these words:

"We believe that a formula should be devised which will limit the participation of the preferred stock purchased by the management to an amount which takes into account the purchase prices paid, plus accumulated dividends since the dates of the respective purchases. We do not now attempt to indicate what that formula should be, since the matter is complicated by the fact that the apportionment of stock among the several series of preferred stocks is to be based upon their respective dividend rates and dividend accumulations rather than upon their liquidation values. Our staff will be available for consultation with Federal with respect to this matter, and we shall give further consideration to this question if and when Federal files amendments to its proposal."

Why in the Commission's subsequent report the phrase "purchase price plus accumulated dividends" was deleted and "cost plus 4 percent" adopted in its place, we have no means of knowing, but the language we have quoted and the facts we have recited unmistakably show that in what is proposed the Commission was adventuring with uncertain steps into a brand new field in which there was neither guide nor compass in the Act or in any administrative practice, either in the Commission or elsewhere.

Certainly this expansion of power cannot be said to conform to the Senate Committee's admonition in reporting the Securities and Exchange Act, that the Commission's authority *must* be administered within the well defined limits of the Act.

Nor is there anything in the Act which changes the established rule, except to the extent we are about to mention. During its consideration by Congress, there was much discussion on the subject of the use by corporate officers of inside information in dealing in its shares. The discussion was general and exhaustive. After extended hearings,

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8 W. 688; Cowell v. Jackson, 53 N. J. L. 656, 22 Atl. 426; Carpenter v. Danforth, 32 Barb. 584; Krumbhaar v. Griffiths, 151 Pa. 223, 25 Atl. 64; Commonwealth Title Ins. & T. Co. v. Seltzer, 227 Pa. 419, 76 Atl. 77, 136 Am. St. Rep. 896; Fisher v. Budlong, 10 R. I. 525; Deaderick v. Wilson (Tenn.), 8 Baxt. 108; Haarstick v. Fox, 9 Utah 119, 33 Pac. 251; O'Neile v. Ternes, 32 Wash. 521, 73 Pac. 692; Voellmeck v. Harding, 166 Wash. 93, 6 P. (2d) 373; Poole v. Camden, 79 W. Va. 319, L. R. A. 1917E 988, 92 S. E. 454.

Congress settled the problem in Section 17 of the Act, by requiring every officer or director of a registered holding company to report within ten days a statement of the securities owned by him in the company or in a subsidiary and, within ten days after the beginning of each month, to make a like report showing all purchases and sales. This was obviously for purposes of publicity. To prevent the unfair use of "inside information" by the management, Congress further enacted that any profit derived from any purchase and sale or sale and purchase within any holding period of less than six months should inure to the corporation. Senator Fletcher, in reporting the Securities Exchange Act of 1934, from which Section 17 of the Public Utility Act of 1935 was bodily taken, said of that section:

"The bill further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation, the stock of which is traded in on exchanges, from speculating in the stock on the basis of information not available to others. Any change in the holdings of such insiders must be reported to the Commission, and profits realized from the purchase and sale, or the sale and purchase of an equity security within a period of less than 6 months are recoverable by the corporation. Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others. * * *

The principal objection directed against the provisions for corporate reporting is that they constitute a veiled attempt to invest a governmental commission with the power to interfere in the management of corporations. The committee has no such intention, and feels that the bill furnishes no justification for such an interpretation. To make this point abundantly clear, section 13 (d) specifically provides that nothing in the act shall be construed to authorize interference with the management of corporate affairs."*

Clearly, the enactment of Section 17 was intended to restrict a recognized existing right and place a definite and certain limitation on its exercise. But subject to its provisions, officers and directors of a corporation are permitted to deal in its securities. Of this, and of the exercise of the right, day after day, without question, there can be no manner of doubt. And this is just a recognition by Congress of the rule that, while officers and directors are trustees for stockholders as a body with respect to the business and property of the corporation and in the management of its affairs, they are not trustees—in the sense we are concerned with here—to the individual stockholder, since they have no control over his shares. Strong v. Repide, 213 U. S. 419, 431; Bisbee v. Midland L. P. Co., 19 F. 2d 24; Dunnett v. Arn, 71 F. 2d 912; Bawden v. Taylor, 254 Ill. 464, 98 N. E. 941; Anchor Realty

*Senate Report No. 792, 73d Cong., 2d Sess., pp. 9-10

& Investment Co. v. Rafferty, 308 Ill. App. 484, 32 N. E. 2d 394; Seitz v. Frey, 152 Minn. 170, 188 N. W. 266. Of course, they may not manipulate the affairs of the corporation in the interest of themselves or one group of stockholders to the hurt of another, and many courts recognize the duty of full and free disclosure in advance of transactions involving a transfer of shares of the corporation. But the rule goes no further. Strong v. Repide, supra; Tripplett v. Polaris, 110 F. 2d 362; Westwood v. Continental Can, 80 F. 2d 494. In applying the rule, courts have held that an officer may not purchase securities of the corporation without disclosing special facts of which he has knowledge and which tend to affect the value of the securities. But these exceptions and the limitations prescribed by Congress to the general rule are inapplicable here, for it is admitted that there was a full and free disclosure before any purchases were made, the exercise of the utmost good faith throughout, due report to the Commission, the expiration of years, rather than months, after purchase, and no sale. The Commission, however, considers these facts immaterial. It says that "honesty, full disclosure, and purchase at a fair price" are not enough; that in submitting to the Commission a voluntary reorganization plan the directors occupy a fiduciary position toward all the security holders; and that, notwithstanding the fairness of the plan submitted and the exercise of the utmost good faith in its submission, the very fact that it was initiated by the directors places them in the category of a "stockholders' protective committee" or a "stockholders' reorganization committee", as to which the rule is that they may not deal in the securities committed to their care.

Authority for this, the Commission seeks to find in two distinct types of cases. Representative of the first, is Pepper v. Litton, 308 U. S. 295, followed by American Ins. Co. v. Avon Park, 311 U. S. 138, and Woods v. City Bank Co., 312 U. S. 262. The Pepper case involved a "planned and fraudulent scheme" by the dominant stockholder of a corporation to defraud other creditors in prosecuting an alleged claim for accrued salary. The Avon Park case involved a fiscal agent of a municipality who was also a creditor, and who concealed this dual relationship from other creditors. In the Woods case, counsel representing conflicting interests was asking compensation for services in the litigation. Furthermore, all three cases arose under the national bankruptcy law.

In the Pepper case, Mr. Justice Douglas announced certain general rules applicable under the equitable powers of the bankruptcy court, which were later—speaking generally—adopted and approved in the other two cases. He said: "A director is a fiduciary. [citing case] So is a dominant or controlling stockholder or group of stockholders. [case citation] Their powers are powers in trust * * *. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent

fairness from the viewpoint of the corporation and those interested therein. [citation] The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside."

There can be no quarrel with this statement, and we have always so understood the law to be. The question is its application in the facts of this case. Granting that a director is a fiduciary as to his dealings with the corporation, is very far from saying that a director may not purchase shares of the corporation, and the Supreme Court has said nothing to that effect. Indeed, that it had no such purpose is shown by the "test" which it applies to determine the legality of a transaction between a director and the corporation itself, namely, that it shall be "an arm's length bargain". Applying that formula here, the Commission itself has taken the case out of the category of transactions which cannot stand, for it admits that this was an "arm's length bargain." Moreover, this is not a bankruptcy case nor a case for the intervention of the equitable powers of the bankruptcy court. Though again, it is difficult to see that, if it were, that fact, in the circumstances we are considering, would make a difference.

In the second class of cases to which we have referred and to which the Commission seeks to liken petitioners, Re-Paramount Publix Pictures[6] is an example; but we think the resemblance is too attenuated to be real, for in that case an unqualified rule against trading in the shares of a bankrupt corporation was distinctly placed on the ground that, having assumed the duty of representing the depositing stockholders, the committee became the alter ego of the shareholder and was bound, as an attorney would be, by an obligation to refrain from dealing with the properties committed to his care. In that case, as in the case of Republic Gas Corporation,[7] the individual security holders had deposited their securities under a power of attorney which conferred on the committee comprehensive powers, including authority to take all steps necessary to a reorganization and also the power to fix their own compensation. This, as the Supreme Court said in Bullard v. Cisco, 290 U. S. 179, was the equivalent of depositing the securities "into an express trust * * * to be managed and administered by * * * trustees for the purpose of conserving, salvaging and adjusting the investment." But the pattern in this case bears no resemblance to that. The difference between petitioners and a stockholders' committee created to protect its members in winding up or reorganizing an insolvent corporation is striking and obvious. Here, as to the purchases made by petitioners, there is no express trust in which petitioners are trustees, nor are petitioners agents of, nor do they speak for, the shareholders in the proceedings before the Commission. They merely propose the plan—as to which, of course, honesty and fair dealing must be shown—and in the present instance is admitted. The approval is for the Commission, and the confirmation is by act of the stockholders in accordance with State

[6] 12 F. Supp. 823.
[7] 35 F. Supp. 300.

law and in which two-thirds must agree, with the right on the part of a dissenting stockholder to have an appraisement and the value of his shares in cash. The directors' functions are thus wholly different from those of the reorganization committees, to which the courts apply the rule of trustee and beneficiary.

Here we have a case in which the record shows a going corporation with large assets and a money-making record, but which, by losses in previous years, had sustained a capital deficit which prevented the carrying out of its obligations to its preferred stockholders. Its directors, with the object of a resumption of dividends, proposed a plan valid under the applicable State law, for the ratable reduction of its capital structure, the result of which would have been, if approved by the Commission and stockholders alike, to leave the equities precisely as they were in the beginning. Pending action by the Commission, practically the entire issue of each class of preferred stock changed hands in the open market, and there was full knowledge or opportunity of knowledge on the part of buyer and seller alike of the exact situation. The position of petitioners in this respect was the same—no better, no worse—than the position of the other buyers of the stocks. The Commission informally refused to give its approval to the plan or the various amendments proposed from time to time, as it had a right to do. A new and different plan was then proposed, to which the Commission gave approval, and authorized a corporate meeting that the stockholders might express their wish to adopt or to reject it. During all of this time some officers of the company, to protect their investments in the company, purchased in good faith, in the open market, approximately 7½ percent of the preferred stock, and as each purchase was made, reported its terms to the Commission, as the Act required, and the Commission, without protest, released notice of the same to the public. But in its final approval, the Commission, solely for the reason that these purchases were made by men who occupied an official relation to the company, says the transaction is unlawful, and accordingly places the participants in a less favorable position than the hundreds of private purchasers who acquired their shares on exactly the same basis.

This position the Commission defends, not on the ground that the Act of Congress authorizes the exertion by it of such power, but upon a rule of convenience which the Commission is of opinion should obtain. Starting with the premise, which nearly everyone admits, that there have been abuses by officers and directors of corporations in the manipulation of the stocks of their corporation, in the suppression of information in relation to the financial condition of the corporation, and in the use of information not generally available, the Commission says that it is better that the cause of this evil should be prohibited than that the Commission should be relied upon to apply the remedy in particular cases by inquiring into all the circumstances

of the case to determine whether there has or has not been fraud in fact. Since the Commission would, and in this case has, substituted a rule of its own for that which Congress, after considering the subject in all of its various angles, covered in Section 17 of the Act, the question narrows itself to the validity of this Commission action. And we think that question must, on reason and authority, be answered negatively. This apparently was also the view of the Commission until it cut the Gordian knot in the present case, for in its report of August 7, 1941, recommending amendments, it acknowledged that: "It is only when the insider makes a profit within the relatively short period of 6 months that this profit is required to be turned over to the corporation."

And that the Commission thought this was sufficient to strike at the root of the evil is shown by the statement of Chairman Purcell to the House Committee on Interstate Commerce (January 23, 1942), "that Congress was wise in seeking to deal with the problem" covered by Section 17 (16 in Securities Act) "by expressly prohibiting only the most prevalent form of the abuse of inside information—trading designed to take quick profits from short term market fluctuations." And yet the Commission proposes to annul, not transactions growing out of an abuse of inside information, but transactions as to which both buyer and seller were equally informed of the facts—not trading designed to take quick profits from short term market fluctuations, but trading for investment by one whose income depended at least in part upon the success of the corporation of which he was an officer.

That this assumption of authority is contrary to the Congressional intent, we think we have shown, and that such assumption was never contemplated by Congress is clear in the report of Senator Fletcher, to which we have referred, where he says: "Of course, well defined limits must be indicated within which the authority of such administrative authority may be exercised."

We have pointed out these limits, and now to hold with the Commission would require us to say that a transaction which the general law recognizes as lawful, and to which Congress for reasons of its own has attached conditions, is detrimental to the public welfare, notwithstanding no breach of the conditions is shown. In our opinion, in the enactment of Section 17, the congressional phrase "detrimental to the public interest" was never intended to proscribe an investment made under these circumstances.

In expressing this opinion, we are not saying that the Commission's view is not directed to a desirable end. As to that, opinions of men of experience and probity and judgment will differ widely. But, if the Commission's objective is to be attained, it should be only after the pros and cons have been carefully weighed in their relation, respectively, to the dangers and the benefits, and the scales should be controlled by Congress and not by the Commission. In short, all that we hold is that this vital question of policy is one for the Congress

and not for the Commission. Until Congress acts to change the standard it has expressly set up in the Act, action by the Commission to expand or enlarge its terms, and to make such expansion, or enlargement apply to transactions three years old, is we think, with great deference to the Commission, neither more nor less than retrospective legislation.

The order of the Commission is, therefore, reversed and the cause remanded to the Commission for action in accordance with this opinion. Reversed and remanded.

MILLER, Asociate Justice, dissenting: The delay in approval by the Commission of petitioners' plan is adequately explained by the following considerations: (1) During the intervening four-year period four plans—fourteen times amended—were submitted to the Commission; (2) but only in the last plan as finally amended was provision made for the elimination of the Class B stock; (3) this Class B stock controlled the voting power of the corporation; (4) it also constituted petitioners' main interest in the enterprise and they were the dominant stockholders because of their control of it; (5) petitioners do not now question the power of the Commission to find that the Class B stock represented no real equity and that it would have been unfair and inequitable to the other stockholders if it had not been eliminated; (6) whatever may have been the motive or the reason for so long delaying the elimination of the Class B stock, it was through no misconduct or nonfeasance upon the part of the Commission; (7) the law gave to petitioners the initiative in preparing and presenting to the Commission an acceptable plan; (8) and it gave to petitioners the privilege of not carrying out the plan even after approval.

The question presented for our decision is whether the Commission had power to impose, as a condition of approval of the plan as finally presented, a limitation upon the extent to which petitioners may profit from the purchase, during the intervening four-year period, of other stock of the corporation. The statute provides specifically that: "Any order permitting a declaration to become effective may contain such terms and conditions as the Commission finds necessary to assure compliance with the conditions specified in this section."[1] [Italics supplied.] The Commission found it necessary to impose the protested condition in order to secure compliance with the italicized language of the following broad specification of the statute: " * * * the Commission shall permit a declaration to become effective regarding the exercise of a privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security unless the Commission finds that such exercise of such privilege or right will result in an unfair or inequitable distribution of voting power among holders of the securities of the declarant or is otherwise detrimental to the public interest or the interest of investors or consumers."[2] [Italics supplied.]

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[1] 49 Stat. 817, 15 U. S. C. § 79g (f).
[2] 49 Stat. 816, 15 U. S. C. § 79g (e).

I see no reason for questioning the Commission's finding or for limiting the broad language of the statute as the majority opinion proposes to do. The statute vested a large discretion in the Commission. It is a rule of long standing that the exercise of such discretion should not be disturbed except where it has been abused.[3] The Supreme Court has admonished us on several occasions that the judicial function is a limited one, quickly exhausted,[4] and that courts should not lightly interfere with the performance of administrative duties by the agencies which Congress has created for that purpose.[5] Courts and commissions should play a coordinate role in the administration of justice.[6]

Whether the conduct of petitioners in the present case would be proscribed or permitted by any rule of common law or equity, declared by any court prior to adoption of the acts which created, implemented and empowered the Commission, is of small significance. While it may be entirely proper to look to the common law for definition when the context of a statute so requires,[7] it is improper to do so when the statute deliberately departs from the common law definition "or when its purpose would be defeated by adherence to a common law rule.[8]" A closely related example is found in the Federal Trade Commission Act. Justice Stone, speaking for the Supreme Court in Federal Trade Commission v. R. F. Keppel & Bro., Inc.,[10] used language strikingly pertinent to the present case: "The Common law afforded a definition of unfair competition and, before the enactment of the Federal Trade Commission Act, the Sherman Act had laid its inhibition upon combinations to restrain or monopolize interstate commerce which the courts had construed to include restraints upon competition in interstate commerce. It would not have been a difficult feat of draftsmanship to have restricted the operation of the Trade Commission Act to those methods of competition in interstate commerce which are forbidden at common law or which are likely to grow into violations of the Sherman Act, if that had been the purpose of the legislation. * * * As proposed by the Senate Committee on Interstate Commerce and as introduced in the Senate, the bill which ultimately became the Federal Trade Commission Act declared 'unfair competition' to be unlawful. But it was because

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[3] Interstate Commerce Commission v. Illinois Central R. R., 215 U. S. 452, 470; Alabama Power Co. v. Federal Power Commission, (No. 7853, decided March 30, 1942) — App. D. C. —, — F. (2d) —.

[4] Rochester Tel. Corp. v. United States, 307 U. S. 125, 139–140; Mississippi Valley Barge Line Co. v. United States, 292 U. S. 282, 286–287; Federal Communications Commission v. Pottsville Broadcasting Co., 309 U. S. 134, 143.

[5] Board of Trade v. United States, (No. 143, decided January 5, 1942) 10 U. S. L. Week 4119, 4122.

[6] Scripps-Howard Radio, Inc., v. Federal Communications Commission, (No. 508, decided April 6, 1942) 10 U. S. L. Week 4322, 4324; United States v. Morgan, 307 U. S. 183, 191; id. 313 U. S. 409, 422; Federal Communications Commission v. Pottsville Broadcasting Co., 309 U. S. 134, 146.

[7] See Apex Hosiery Co. v. Leader, 310 U. S. 469, 494–498; United States v. American Medical Ass'n, 72 App. D. C. 12, 16, 110 F. (2d) 703, 707, cert. denied, 310 U. S. 644; United States v. Cardish, E. D. Wis., 147, F. 640, 642; Oliver v. United States, 9 Cir. 230 F. 971, 973, cert. denied, 241 U. S. 670.

[8] Federal Trade Commission v. R. F. Keppel & Bro., Inc., 291 U. S. 304, 310–312.

[9] Philadelphia, Baltimore & Washington R. R. v. Tucker, 35 App. D. C. 123, 148, aff'd, 229 U. S. 608; Commissioner of Internal Revenue v. Marshall, 2 Cir., 125 F. (2d) 943, 945; Missel v. Overnight Motor Transp. Co., Inc., 4 Cir., 126 F. (2d) 98, 102–103.

[10] 291 U. S. 304, 310–312.

the meaning which the common law had given to those words was deemed too narrow that the broader and more flexible phrase 'unfair methods of competition' was substituted. Congress, in defining the powers of the Commission, thus advisedly adopted a phrase which, as this Court has said, does not 'admit of precise definition but the meaning and application of which must be arrived at by what this Court elsewhere has called "the gradual process of judicial inclusion and exclusion."'" The broad and far-reaching standard of public interest which is declared in the present Act, has been used by Congress in earlier legislation and has been liberally interpreted by the Supreme Court to accomplish the statutory purpose. A good example is found in the Transportation Act of 1920,[11] as interpreted in such cases as United States v. Lowden,[12] and Interstate Commerce Commission v. Railway Labor Executives Ass'n.[13]

In the present case, therefore, as in the instances to which reference has been made, courts are obliged to interpret statutory revisions of common law in such manner as to achieve, rather than to defeat their purposes;[14] regardless of the extent to which they may seem to depart from the old common law moorings.[15] An examination of the applicable law and the Committee Reports,[16] in the present case, reveals that it was the intention of Congress to work sweeping changes in theretofore existing rules governing corporate management, financing and reorganization.[17] Those changes are as far-reaching in their implications as was the abandonment of the common law rule of assumption of risk and the fellow-servant rule, which resulted from enactment of workmen's compensation and industrial accident legislation.[18] Here, as there, the purpose was to protect little people against the aggressions of the dominant group. Consequently, we should look for analogies to other branches of the law in which the legal relationships more nearly approximate those which Congress intended should

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[11] 41 Stat. 477, § 402 (18), 49 U. S. C. § 1 (18); Id. at 481, § 407 (5), (6), 49 U. S. C. § 5 (2).

[12] 308 U. S. 225, 231, 232, 238, 240.

[13] (No. 223, decided March 2, 1942), 10 U. S. L. Week 4249, 4250.

[14] Philadelphia, Baltimore & Washington R. R. v. Tucker, 35 App. D. C. 123, 148, aff'd. 226 U. S. 608; United States v. American Trucking Ass'ns, Inc., 310 U. S. 534, 542, 544: "In the interpretation of statutes, the function of the courts is easily stated. It is to construe the language so as to give effect to the intent of Congress. . . . Emphasis should be laid, too, upon the necessity for appraisal of the purposes as a whole of Congress in analyzing the meaning of clauses or sections of general acts."

See also Federal Trade Commission v. Bunte Brothers, Inc., 312 U. S. 349, 351: ". . . the construction of every such statute presents a unique problem in which words derive vitality from the aim and nature of the specific legislation."

[15] Pennsylvania Indemnity Fire Corp. v. Aldridge, 73 App. D. C. 161, 117 F. (2d) 774.

[16] Sen. Rep. No. 792, 73d Cong., 2d Sess. (1934) 1-21. See particularly [p. 3]: "The record, compiled by the committee for the first time exposed methods by which a relatively small number of persons have extended their operations in securities far beyond any useful economic function, to the great detriment of the investing public. . . . [p. 11] A memorandum prepared by a corporate official was introduced in evidence which discussed the alternatives of preparing the corporation's annual report in either the 'standard' or the 'understandable' form, the decision being in favor of the former. Many other instances of 'window dressing' were observed, where inexcusable methods were employed to inflate assets, obscure liabilities, and conceal deficits."

Sen. Rep. No. 1455, 73d Cong., 2d Sess. (1934) 68: "The Securities Exchange Act of 1934 aims to protect the interests of the public against the predatory operations of directors, officers, and principal stockholders of corporations by preventing them from speculating in the stock of the corporations to which they owe a fiduciary duty. Every person who is the beneficial owner of more than 10 percent of any class of equity security (registered on an exchange or who is a director or officer of the issuer of such security must report to the Commission whenever any change occurs in his ownership of stock in the corporation. In the event that he realizes any profits from the purchase and sale

exist henceforth in the management, administration and reorganization of public utility holding companies.

The obvious analogy, it seems to me, is the relationship which exists between the trustee and his beneficiary. And, in my opinion, the Commission's contention is correct, within the meaning of the Act, that those who undertake to formulate and secure approval of a plan for the readjustment of stockholders' rights thereby assume fiduciary obligations to the stockholders whose rights the plan proposes to affect, and their judgment and conduct in such an undertaking should not be open to influences arising from the possibility of personal profit through the purchase of securities subject to the plan; consequently, that they should not profit; in the consummation of the plan, through purchases made while such fiduciary obligations continue. It is in this sense that such cases as Pepper v. Litton,[19] American United Mutual Life Insurance Co. v. Avon Park,[20] and Woods v. City National Bank and Trust Co.[21] become applicable to the present case. For the same reason an analogy may properly be drawn between the present case and those which prohibit dealing, by a committee member, in securities of the company which he is attempting to reorganize.[22] It is even more important in the present situation, that the supervisory power of the Commission should be recognized, in order that the purpose of the statute may be achieved, because, while in a bankruptcy case there is opportunity for the court, before the estate is finally

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or sale and purchase of an equity security within a period of less than 6 months, he is bound to account to the corporation for such profits. It is also made unlawful for corporate insiders to sell the security of their corporations short or to make 'sales against the box.' By this section it is rendered unlawful for persons intrusted with the administration of corporate affairs or vested with substantial control over corporations to use inside information for their own advantage."

Sen. Rep. N. 621, 74th Cong., 1st Sess. (1935) 59: "The issuance of new securities by holding companies should be adequately supervised by the commission so that in reorganizations and rearrangements of properties an uninformed investing public shall not have foisted upon it securities which are in no sense secure and carry little or no voice in management. Security issues should be limited to purposes necessary in the public interest, which accords with the ultimate purposes of the legislation; and each security issued should bear a proper relation to the capital of the company, its existing securities, the securities of the companies in a geographically and economically related system, and, above all, to the prudent investment in the properties of the issuer and its underlying companies. There should be an end to the pyramiding of holding company securities. Except for necessary discretionary power in the commission in the case of refunding issues, new securities should be limited to par value common stock, with appropriate voting rights, and to first lien bonds, i. e., bonds having a first lien either on physical assets of the issuer or upon first mortgage bonds of operating subsidiaries. In this as in almost every phase of the holding company problem the ultimate interests of consumers and investors are identical. In a system burdened with overcapitalized and debt-ridden holding companies, the consumers of operating subsidiaries have to support the topheavy structure by paying high rates and by enduring poor service from inadequately maintained plants."

[17] Public Utility Holding Company Act of 1935, 49 Stat. 803–804, 15 U. S. C. § 79a (a) (b) (c).

[18] St. Louis v. United Railways Co., 210 U. S. 266, 294–295; Hartford Accident & Indemnity Co. v. Cardillo, 72 App. D. C. 52, 58, 112 F. (2d) 11, 17, cert. denied, 310 U. S. 649, 308 U. S. 595, 306–307: "A director is a fiduciary. Twin-Lick Oil Co. v. Marbury, 91 U. S. 587, 588. So is a dominant or controlling stockholder or group of stockholders. Southern Pacific Co. v. Bogert, 250 U. S. 483, 492. Their powers are powers in trust. See Jackson v. Ludeling, 21 Wall. 616, 624. • • • While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.

[19] 311 U. S. 138.

[20] 312 U. S. 262, 268–269.

[21] In re Paramount-Publix Corp., S. D. N. Y., 12 F. Supp. 823, 828, aff'd. 85 F. (2d) 588, cert. denied, 300 U. S. 655; In re Republic Gas Corp., S. D. N. Y., 35 F. Supp. 300, 303–306.

closed to examine every detail of its administration, in the present case the Commission cannot supervise the consummation of the plan or even require that it be consummated.[23] Its duty, in aproving or disapproving, is preventive rather than corrective. In other words, the conventional judicial function of decision after the event may, in a case such as the present, become the least important function of an administrative agency. Such agencies are required to look ahead; indeed, they are charged with the duty of prophecy.[24] For this reason it is sufficient for the determination of conditions under which permission is given to enjoy a legislative privilege in the future, that the expert administrative agency in applying a public interest standard, shall find such conditions reasonably necessary to achieve the purpose and to protect the public interest in the future. To argue the contrary is no more convincing than to argue that a trustee in the conventional trust situation[25] should be allowed to profit from dealings with the trust res unless it can be shown in each case that there has been overreaching upon his part. The purpose of the law is, in each case, to anticipate and prevent overreaching, rather than to discover and punish overreaching after it has occurred. Any other interpretation of the law would impose such an intolerable burden upon the Commission as to make the performance of its duties impossible.[26]

Petitioners contend and the majority opinion holds that the Commission's action in the present case is an attempt to experiment in a field preempted by Congress in the enactment of Section 17 of the Act. I find nothing in Section 17 which suggests Congressional intent to limit the broad power conferred upon the Commission in Section 7. If it had been the intention of Congress that the Commission should have no more power, in acting upon proposals such as the one here involved, than to impose, as conditions of approval, the limitations

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[23] The power to withdraw declarations filed under Section 7 is impliedly contained in Section 7 (b), 49 Stat. 815, 15 U. S. C. § 79g (b). The Commission may apply to a court to enforce the consummation of a plan for simplification of holding companies only at the request of a company. 49 Stat. 822, § 11 (e), 15 U. S. C. § 79k (e). It has been held that an application for registration may be withdrawn at any time before it becomes effective, in the absence of prejudice to the public or to investors. Jones v. Securities & Exchange Commission, 298 U. S. 1, 18-25. Justices Cardozo, Stone and Brandeis dissenting.

[24] Board of Trade v. United States, (No. 143, decided January 5, 1942) 10 U. S. L. Week 4116, 4122. "And judgment in a situation like this implies, ultimately, prophecy based on the facts in the record as illumined by the seasoned wisdom of the expert body. In this perspective, the Commission had several choices before it—but all inevitably rested upon trial and error."

[25] Michoud v. Girod, 4 How. (U. S.) 503, 557: "Is it not better that the cause of the evil shall be prohibited, than that courts of equity shall be relied upon to apply the remedy in particular cases, by inquiring into all the circumstances of a case, whether there has or has not been fraud in fact?"

Magruder v. Drury, 235 U. S. 106, 119: "The intention is to provide against any possible selfish interest exercising an influence which can interfere with the faithful discharge of the duty which is owing in a fiduciary capacity."

Meinhard v. Salmon, 249 N. Y. 458, 464, 164 N. E. 545, 546: "A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. * * * Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court."

[26] See United States v. Trenton Potteries Co., 273 U. S. 392, 397-398; Bethlehem Steel Co. v. National Labor Relations Board, — App. D. C. —, —, 120 F. (2d) 641, 647; Alabama Power Co. v. Federal Power Commission, (No. 7853, decided March 30, 1942) — App. D. C. —, — F. (2d) —.

specified in Section 17, it would have been easy for it to speak in those terms.[27] But it did not so speak; and there is no language in Section 17 which, directly or by implication, defines or limits the power of the Commission to impose "such terms and conditions as * * * [it] finds necessary"[28] to insure that the exercise of the privilege, granted by Congress, to file a declaration with the Commission,[29] shall not be detrimental to the public interest or the interest of investors or consumers.[30] In fact, to limit the language of Section 7 in the manner proposed would deprive it of meaning and defeat one of the larger purposes of the Act. Consequently, in my opinion, the petition should be denied.

Monday, April 27th, A. D. 1942

Before the Honorable D. Lawrence Groner, Chief Justice, and The Honorable Justin Miller and Fred M. Vinson, Associate Justices

No. 8074. April Term, 1942.

Chenery Corporation; H. M. Erskine, R. H. Neilson, et al., petitioners

vs.

Securities and Exchange Commission, respondent; Federal Water and Gas Corporation, intervenor

Petition for review of order of Securities and Exchange Commission

This cause came on to be heard on the transcript of the record from the Securities and Exchange Commission and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the order of the said Securities and Exchange Commission in this cause be, and the same is hereby, reversed, and that this cause be, and it is hereby, remanded to the said Securities and Exchange Commission for further proceedings in conformity with the opinion of this Court.

Per Mr. Chief Justice Groner, April 27, 1942.

Dissenting opinion by Mr. Justice Miller.

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[27] See Federal Trade Commission v. R. F. Keppel & Bro., Inc., 291 U. S. 304, 310.
[28] 49 Stat. 817, § 7 (f), 15 U. S. C. § 79g (f).
[29] 49 Stat. 815, 814, §§ 7 (a), 6 (a), 15 U. S. C. §§ 79g a), 79f.
[30] 49 Stat. 816, § 7 (e), 15 U. S. C. § 79g (e).

In the United States Court of Appeals for the District of Columbia

No. 8074

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

Filed May 29, 1942. Joseph W. Stewart, Clerk.

Designation of Record

The Clerk will please prepare and certify a transcript of record on petition for certiorari to the Supreme Court of the United States in the above entitled case, including therein the following:

1. The appendices to the briefs of the petitioner and respondent.
2. Petition of Federal Water and Gas Corporation for leave to intervene, to file a brief and to participate in oral argument, and order allowing intervention.
3. Minute entry of argument.
4. Opinion.
5. Judgment.
6. This designation.
7. Clerk's certificate.

The Clerk is also requested to send to the Clerk of the United States Supreme Court the original record now on file in his office, which will be returned to him when the case has been disposed of by the Supreme Court.

CHARLES FAHY,
Solicitor General of the United States.

Service of copy of the above designation of record in the above entitled cause is hereby acknowledged this 23 day of May, 1942.

SPENCER GORDON,
Attorney for Chenery Corporation, et al.
CHARLES E. HUGHES, JR.,
ALLEN S. HUBBARD,
Attorneys for Intervenor,
Federal Water and Gas Corporation.

United States Court of Appeals for the District of Columbia

I, Joseph W. Stewart, Clerk of the United States Court of Appeals for the District of Columbia, hereby certify that the foregoing pages numbered from 1 to 159, inclusive, constitute a true copy of the ap-

pendices to the briefs of the parties and proceedings of the said Court of Appeals as designated by the Solicitor General in the case of: Chenery Corporation, H. M. Erskine, R. H. Neilson, et al., petitioners, vs. Securities and Exchange Commission, No. 8074, April Term, 1942, as the same remain upon the files and records of said Court of Appeals.

In testimony whereof, I hereunto subscribe my name and affix the seal of said Court of Appeals, at the City of Washington, this twenty-ninth day of May, A. D. 1942.

[SEAL.]

(Sgd) JOSEPH W. STEWART,
Clerk of the United States Court of Appeals for the District of Columbia.

In the Supreme Court of the United States

October Term, 1941

No. —

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., RESPONDENTS

Stipulation

Subject to this Court's approval, it is hereby stipulated and agreed, by and between the attorneys for the respective parties hereto, that for the purpose of the Petition for a Writ of Certiorari, the printed record may consist of the following:

1. Appendix to the Petitioners' brief in the United States Court of Appeals for the District of Columbia.

2. Appendix to the Respondent's brief in the United States Court of Appeals for the District of Columbia.

3. The proceedings had before the United States Court of Appeals for the District of Columbia.

It is further stipulated and agreed that Petitioner will cause the Clerk of the United States Court of Appeals for the District of Columbia to file with the Clerk of the Supreme Court the entire transcript of record in the Court of Appeals for the District of Columbia; and that, in the event that the Petition for Writ of Certiorari be granted, the printed record shall consist of the proceedings in the court below and such portions of the entire transcript of record as the parties may designate.

It is further stipulated and agreed that either of the parties hereto may refer in their briefs and argument to the original record filed in the Supreme Court of the United States, which has not been printed.

CHARLES FAHY,
Solicitor General.

May 16, 1942.

SPENCER GORDON,
Attorney for Respondents.

May 23, 1942.

CHARLES E. HUGHES, JR.;
ALLEN S. HUBBARD,
Attorneys for Intervenor, Federal Water and Gas Corporation.

May 26, 1942.

U. S. GOVERNMENT PRINTING OFFICE 1942

Supreme Court of the United States

Order allowing certiorari.

Filed October 12, 1942

The petition herein for a writ of certiorari to the United States Court of Appeals for the District of Columbia is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Douglas took no part in the consideration or decision of this application.

U. S. GOVERNMENT PRINTING OFFICE: 1942

FILE COPY

JUL 23 1942
CHARLES ELMORE CROPLEY

No. 254

In the Supreme Court of the United States

OCTOBER TERM, 1942.

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. —

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

The Solicitor General, on behalf of the Securities and Exchange Commission, prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the District of Columbia entered April 27, 1942.

OPINIONS BELOW

The opinion of the Court of Appeals and the dissenting opinion of Justice Miller (R. 139–155) are reported in 128 F. (2d) 303. The Findings and Opinion of the Commission dated March 24, 1941 (R. 63–79, 115–132) are reported in 8 S. E. C. 893. The Supplemental Findings and Opinion of

the Commission (R. 104–113) and the Report of the Commission on a Plan of Reorganization (R. 97–104), both dated September 24, 1941, are reported in S. E. C. Holding Company Act Release No. 3023.

JURISDICTION.

The judgment of the Court of Appeals was entered April 27, 1942 (R. 155). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, made applicable by Section 24 (a) of the Public Utility Holding Company Act of 1935.

QUESTION PRESENTED

Directors and officers of a registered holding company purchased preferred stock of the company during a period in which the management of the company, which they controlled, proposed to the Securities and Exchange Commission successive plans of reorganization pursuant to the Public Utility Holding Company Act of 1935. The Commission denied effectiveness to a plan which provided that the preferred stock so purchased should participate in the reorganization on a parity with all other preferred stock. Thereafter the plan was amended to provide that the preferred stock so purchased, unlike all the other preferred stock, would not be converted into stock of the reorganized company, but might be sold to the reorganized company at cost plus interest.

Over the objection of the directors and officers involved, the Commission approved the plan as amended.

The question is whether the Court of Appeals erred in setting aside the Commission's findings and order which determined that it would be detrimental to the interests of investors and unfair and inequitable within the meaning of the Act to allow the preferred stock so purchased to participate in the reorganization on a parity with all the other preferred stock.

STATUTE INVOLVED

The pertinent provisions of the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 803, are set forth in the Appendix, *infra*, pp. 20–28.

STATEMENT

Prior to the consummation of the merger approved in the Commission's order (R. 111–113), Federal Water Service Corporation (hereinafter called "Federal") was a registered holding company incorporated in Delaware controlling subsidiaries which operated water, gas, electric and other properties in thirteen states and in one foreign country (Tr. 457–458). The respondents all were stockholders in Federal and, with the exception of Chenery Corporation, a family holding company controlled by C. T. Chenery, the president of Federal, were either directors or officers of Federal or its parent, Utility Operators Company, or

both (R. 13, 85–86). The individual respondents and C. T. Chenery controlled Utility Operators, which owned all of the outstanding shares of Federal's Class B common stock (R. 63–64). Since this stock represented 42.73% of the voting power in Federal, and since the other voting stock was scattered among public holders, respondents and C. T. Chenery controlled Federal through Utility Operators (Tr. 14, 1597). Federal Water and Gas Corporation (hereinafter called "Federal Gas") was a wholly-owned inactive subsidiary of Federal with no important assets (R. 64).

Federal registered as a holding company under the Act on November 8, 1937. Concurrently, it filed with the Commission a declaration under Section 7 of the Act with respect to a plan for the alteration of the rights of its security holders. The plan was designed to eliminate a mounting capital deficit and to release earnings for payment of dividends on its stock (Tr. 10), which at the time consisted of preferred, Class A and Class B shares of the stated value of approximately 15, 13½ and 2½ million dollars, respectively (Tr. 40). The preferred shares had dividend and liquidation preferences over the Class A and Class B shares and the Class A shares had comparable preferences with respect to the Class B (Tr. 3–4). No dividends had been paid since 1931 and in none of the years 1932 to 1937 had income, even on a consoli-

dated basis, been sufficient to meet the preferred dividend requirements (Tr. 47–73). On November 7, 1937, dividend arrearages on the preferred amounted to nearly $6,000,000 and on the Class A to approximately $7,000,000 (Tr. 41). If an admitted excess of book values of investments over their true values had been corrected on the books, the surplus deficit would have exceeded the stated value of the Class B stock and impaired the stated value of the Class A (Tr. 40–41, 92–95).

This circumstance furnished an important incentive to recapitalization, since under Delaware law no dividends could be paid on any class of stock as long as the capital represented by any class having a preference on distribution of assets was impaired (R. 65).[1] As was indicated by the Commission (R. 66), another incentive to voluntary recapitalization was the fact that Federal was confronted with the prospect of compulsory simplification of its capital structure under Section 11 (b) (2) of the Act.

Through their control of Utility Operators, the principal asset of which was the Federal Class B stock, the management of Federal had a greater interest in the Class B stock than in the preferred or Class A shares. The plan embodied in the declaration filed by Federal on November 8, 1937, and two somewhat different plans subsequently

[1] General Corporation Law of Delaware, Section 34 (1935); Del. Rev. Code (1935), § 2066.

proposed by Federal, called for participation by the Class B stock in the reorganized company. These plans were discussed informally with representatives of the Commission, and formal hearings on each were held before a trial examiner. Ultimately all of these plans were withdrawn. A principal obstacle to approval of them was the provision for participation by the Class B stock, which had no existing or prospective equity in the assets or earnings of the enterprise. (R. 67.)

On March 30, 1940, the management filed a fourth plan (Tr. 782–799). This plan proposed a merger of Federal, Utility Operators and Federal Gas. There was no provision for participation by the Class B stock, which was to be surrendered for cancellation; but a provision for a "staggered" board of directors would — initially at least — retain the existing management in control. The preferred and Class A shares of Federal were to be converted into common shares of the surviving corporation. (R. 67–69.) Hearings on the plan were held before a trial examiner, after which tentative findings and an opinion were prepared by the Commission and served on the parties. Thereafter, counsel for Federal and counsel for the Commission filed briefs and were heard in oral argument before the Commission. (R. 67–68.) On March 24, 1941, the Commission issued findings and an opinion denying effectiveness to the plan on three

grounds. (R. 63–79.) One ground was that the par value of the common stock to be issued was fixed at too high a figure. A second ground was that the "staggered" board provision would result in an unfair distribution of voting power. The third ground presents the only issue now involved.

With respect to this ground, the Commission found that during the period from November 8, 1937, to June 30, 1940, when Federal's plans of reorganization were on file or under discussion with the Commission, the respondents purchased a total of 12,407 shares of Federal's preferred stock. Most of these shares were purchased on the over-the-counter market. They were purchased at prices below the book value of the common stock of the surviving corporation into which they were to be converted under the plan. There was testimony that after individual stockholders had complained of some of the purchases, the respondents adopted a policy of not buying stock while particular plans were in contemplation but not announced publicly, and the Commission did not find fraud or concealment of information. (R. 71–72.) The Commission concluded, however, that the respondents had a fiduciary obligation to the stockholders not to trade in stock of the corporation during the period involved, and it made ultimate findings that, unless amended, the provisions in the plan allowing the preferred

shares purchased in violation of this obligation to participate on a parity with all other preferred shares would result in the terms of issue of the new securities being detrimental to the interests of investors and in the plan being unfair and inequitable within the meaning of Sections 7 and 11 of the Act (R. 77–79).

On July 1 and August 12, 1941, after further informal discussions, the management filed amendments to the plan of merger (Tr. 1030, 1046). These included provisions, to which respondents agreed subject to a reservation of any right they might have to review the Commission's action, that no stock in the surviving corporation would be issued for the preferred shares in Federal bought by petitioners after November 8, 1937. Instead, respondents were to sell and the surviving corporation was to buy the shares at the prices paid by respondents plus 4% interest, less the amount of any profits which may have been made by respondents on any sales of the shares. (R. 80–85.)

On August 15, 1941, respondents filed an application for leave to intervene in the proceedings before the Commission and requested the Commission to reconsider the case and to deny effectiveness to the amended plan unless modified to allow the preferred stock purchased by them during the period in question to participate in the reorganization on a parity with the other preferred stock (R. 85–94). The Commission granted

the respondents leave to intervene and to file briefs (R. 96–97). Thereafter, on September 24, 1941, the Commission issued a report on the amended plan (R. 97–103) and issued supplemental findings and an opinion in which, adhering to the views expressed in its earlier opinion on the issue here involved (R. 108), it approved the amended plan (R. 104–111). By order of the same date, the Commission permitted the declarations embodying the amended plan filed by Federal and the other two companies to become effective forthwith subject to the condition that the reorganization and merger be completed prior to November 1, 1941, and to other conditions not necessary to mention here (R. 112–113).

On a petition for review of the Commission's order, in which respondents raised only the issue now involved (R. 1–10), the Court of Appeals, one judge dissenting, upheld respondents' contention that the Commission should have permitted equal participation by the preferred stock purchased by them during the period in question (R. 139–155). Judgment was entered on April 27, 1942, reversing the Commission's order and remanding the cause for further proceedings in accordance with the court's opinion (R. 155).

REASONS FOR GRANTING THE WRIT

In 1937 and thereafter during the next three years Federal Water Service Corporation, a regis-

tered holding company, filed with the Securities and Exchange Commission various plans of reorganization which the management had formulated and which it sought to have the Commission approve pursuant to Section 7 of the Public Utility Holding Company Act of 1935. During the same period, while the plans were under discussion with the Commission, the respondent Chenery Corporation, which was controlled by the president of Federal, and the other respondents, who were certain officers and directors of Federal or its parent company, purchased preferred stock of Federal on the over-the-counter market. In disapproving the fourth plan proposed by the management, and in thereafter approving the plan as amended, the Commission held, in effect, that the preferred stock so purchased should not be converted into stock of a new corporation on the same basis as the other preferred stock, but should be sold to the new corporation at cost, plus interest, less any profits which the holders may have made on sales of other preferred shares similarly purchased.

The Commission grounded its action on findings that, if the preferred stock so purchased were permitted to participate in the plan on a parity with the remainder of the preferred stock of the same series, the terms of issuance of stock of the new corporation would be "detrimental to the

* * * interest of investors" and the plan would not be "fair and equitable to the persons affected" within the meaning of those provisions of Section 7 (e) and Section 11 (e) of the Act, respectively (R. 77, 79). In reversing the action of the Commission, the majority of the Court of Appeals held that the findings were unauthorized by the Act and that the Commission had made a policy determination which was open only to Congress. Whether the Commission's findings are proper under the Act is the sole question presented. It has not been disputed that if they are proper, the treatment of the stock in the plan as amended was appropriate and the order of the Commission valid (see *supra*, pp. 8–9).

1. The question is one of public importance in the administration of the Act and, therefore, should be reviewed by this Court. In several cases now pending before it, the Commission is faced with substantially the same issue as was before it in the instant case.[2] Since each of those cases and any additional similar cases which may arise would

[2] In *Derby Gas & Elec. Corp.*, Holding Company Act Release No. 2875 (July 12, 1941), the Commission made findings similar to those herein. In *The Middle West Corporation*, Holding Company Act Release No. 3580 (June 5, 1942), the Commission withheld decision because of the decision of the Court of Appeals in the instant case. The pendency of at least six other cases involving the issue decided herein has been ascertained from the Commission's files.

be reviewable in the court below,[3] it is appropriate that certiorari be granted in the instant case to settle the difference between the Commission's view and that of the Court of Appeals. Moreover, a determination by this Court will establish a precedent with respect to the extent of the fiduciary obligations of officers and directors of companies needing reorganization which will be an authoritative guide in the hundred or more other situations where—as shown by a study made by the staff of the Commission—recapitalization appears to be required by the standards of Section 11 (b) of the Act (Appendix, *infra*, p. 24).

2. The decision of the court below adopts an erroneous interpretation of the Act and should be reversed in order to effectuate the policies declared by Congress.

Section 6 prohibits registered holding companies from issuing or selling securities and from altering the rights of holders of outstanding securities except, insofar as here material, in accordance with effective declarations filed by them with the Commission under Section 7 (Appendix, *infra*, p. 22). Under paragraphs (d) (6) and (e) of Section 7, however, a declara-

[3] Section 24 (a) of the Act (Appendix, *infra*, p. 27) permits any "person or party aggrieved by an order issued by the Commission" to file a petition for review in the United States Court of Appeals for the District of Columbia, regardless of where he may reside or have his principal place of business.

tion cannot become effective if the Commission finds that the proposed issuance or sale of securities or alteration of rights of security holders would be "detrimental to the public interest or the interest of investors or consumers" (Appendix, *infra*, p. 23). As is further provided in paragraph (f), an order permitting the declaration to become effective may contain such terms and conditions as the Commission finds necessary to assure compliance with the foregoing or other standards specified in Section 7 (Appendix, *infra*, p. 23). The words "detrimental to the public interest or the interest of investors or consumers" are not defined in the Act, but with all other provisions of the statute are to be construed in the light of the policy of the Act to safeguard the interests of investors, consumers and the public (Section 1, Appendix, *infra*, pp. 20–21).

The evident intention of Congress to accord the Commission a broad scope of judgment appears further from Section 11, which also is applicable in the instant case, as was held by the Commission (R. 122–123, 130–131). Under subsection (b) (2) (Appendix, *infra*, p. 24), it is the Commission's duty to order registered holding companies and their subsidiaries to take such steps as the Commission finds necessary to ensure that the structure of holding company systems is not unduly or unnecessarily complicated or that voting

power is not unfairly or inequitably distributed among security holders. Subsection (e) (Appendix, *infra*, pp. 24-26) provides that any registered holding or subsidiary company may submit a plan to the Commission "for the purpose of enabling such company * * * to comply with the provisions of subsection (b)." Approval of the plan is made contingent upon findings by the Commission that the plan, as submitted or as modified, is "necessary to effectuate the provisions of subsection (b)" and is "fair and equitable" to the persons affected by it.

Thus, Congress specifically committed to the Commission the duty of determining whether a proposed change in the rights of security holders would be detrimental to the interests of investors and whether a proposed redistribution of voting power would be fair and equitable. In addition, it authorized the Commission to impose conditions or require modifications. The power of the Commission with respect to changes in the rights of security holders is not limited to changes as between different classes of holders, but extends as well to changes within a particular class. Accordingly, if consistent with the statutory objectives and standards there is an appropriate basis for the Commission's determination in the instant case, the court below should not have reversed. *United States* v. *Lowden*, 308 U. S. 225, 231, and cases cited; *Gray* v. *Powell*, 314 U. S. 402.

We submit that there is such a basis. The Commission held, in substance, that in the process of formulating and presenting to the Commission a plan of reorganization, the management of a registered holding company occupies a fiduciary position toward all the security holders affected by the plan and, under decisions of courts of equity in analogous situations, should not be permitted to obtain advantages by trading for profit in stock of the company even though in the particular case there is no finding of fraud or concealment (R. 72–77, 108). This conclusion tends to promote the statutory purpose of safeguarding the interests of investors and the public, is in accord with sound principles of equity, and does not conflict with anything in the terms or history of the Act.

The management of a registered company in formulating and effecting a plan of reorganization acts in a representative capacity for all the security holders and is in a peculiarly powerful position. Excepting the Commission, only the management may initiate or amend a plan.[4] In a

[4] See *Republic Service Corp.*, Holding Company Act Release No. 3513 (May 9, 1942), in which the Commission held that an individual preferred stockholder could not file a plan of reorganization under Section 11 (e). In cases where a proceeding is instituted by the Commission under Section 11 (b) and application is made to a court under Section 11 (d) to enforce the Commission's order, the plan may be proposed by the Commission or by any person having a bona fide interest in the reorganization.

case such as the present, it may withdraw its proposals at any time before approval and may even fail to carry out a plan after approval. Frequently, through control of timing, control of the provisions of the plan, or through possession of information which is not fully or generally known by the security holders, it could realize profits at their expense if permitted to deal in the securities. The possibilities of abuse and of errors of judgment in representing the security holders which might result from shifts in the interests of management as between different classes of securities call for holding the officers and directors subject to the same standard of conduct as must be observed by trustees and members of protective committees.

It has long been settled that in order to eliminate the cause of evil, a trustee may not purchase property embraced by the trust "though he has done so for a fair price, without fraud, at a public sale." *Michoud* v. *Girod*, 4 How. 502, 557 (1846); *Magruder* v. *Drury*, 235 U. S. 106; *Meinhard* v. *Salmon*, 249 N. Y. 458. Cf. *Woods* v. *City Bank Co.*, 312 U. S. 262, 268. And this rule, for reasons which apply equally in the instant situation, has been extended to members of protective committees in decisions subsequently codified in Section 249 of the Bankruptcy Act (11 U. S. C. § 649).

Under these decisions [5] members of protective committees who dealt in securities of the corporation pending the reorganization have been precluded from obtaining compensation for services rendered during the reorganization. This would seem to be a more severe sanction than that applied in the instant case. The respondents here were precluded only from realizing profits, a result identical with that which Section 212 of the Bankruptcy Act [6] (11 U. S. C. § 612) authorizes a court of equity to reach and which, indeed, a court might reach in the absence of express statutory authorization by application of principles inherent in the standard "fair and equitable." See *American United Mutual Insurance Co.* v. *City of Avon Park*, 311 U. S. 138, 145–146.

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[5] *In re Paramount Publix Corp.*, 12 F. Supp. 823, 828 (S. D. N. Y.), affirmed 83 F. (2d) 1015 (C. C. A. 2); *In re Republic Gas Corp.*, 35 F. Supp. 300 (S. D. N. Y.). See *Otis & Co.* v. *Insurance Bldg. Corp.*, 110 F. (2d) 333 (C. C. A. 1); *In re Mountain States Power Co.*, 118 F. (2d) 405 (C. C. A. 3). The fiduciary obligations of members of protective committees toward the security holders they undertake to represent are not dependent upon the existence of an express trust or upon whether securities are deposited with them. *United States* v. *Buckner*, 108 F. (2d) 921, 926–927 (C. C. A. 2), certiorari denied, 309 U. S. 669. Compare (Note) *Duty of Member of Protective Committee to Disclose Information Before Purchasing Stock From Non-Depositor* (1936), 46 Yale L. J. 143, 148.

[6] Section 212 of the Bankruptcy Act expressly authorizes the court to limit claims or stock purchased by a committee during a reorganization proceeding under that Act to the actual consideration paid therefor.

The court below (R. 143–144, 145–146) relied on Section 17 (b) of the Act (Appendix, *infra*, pp. 26-27) and, in conjunction therewith, on the common law rule of a majority of states, including Delaware, that officers and directors are not trustees of the individual stockholders and are free to trade in stock of the corporation provided they do so without practicing fraud or, in some jurisdictions, concealing knowledge of special facts. Cf. *Strong* v. *Repide*, 213 U. S. 419.[1]

Section 17 (b), which is similar to Section 16 (b) of the Securities Exchange Act of 1934, provides that profits realized by directors or officers from purchases and sales, or sales and purchases, of securities of the corporation within any period of less than six months shall inure to the benefit of the corporation. The court below thought that this provision should be read as prohibiting the Commission from adding any other restriction upon the normal right of directors and officers recognized at common law to purchase securities of the corporation (R. 145, 149–150). However, the common law rule has been developed in private litigation in suits brought by individual stockholders and, so far as we are aware, has not been applied to a reorganization situation in any

[1] The cases are collected and discussed in Yourd, *Trading in Securities by Directors, Officers and Stockholders* (1939) 38 Mich. L. Rev. 133.

case arising under a statute setting up standards comparable to those of the present Act. Nor is there anything in Section 17 (b) or in its legislative history to indicate that Congress meant to limit the power of the Commission in proceedings under Sections 7 and 11. The decision of the Commission herein is in accord with expanding notions as to the scope of the fiduciary obligations of officers, directors and principal stockholders (cf. *Pepper* v. *Litton*, 308 U. S. 295, 306–307; and cases *supra*, pp. 16-17), and is in any event authorized by the Act as a reasonable exercise of administrative judgment.

CONCLUSION

Because of the importance of the question presented, the petition for a writ of certiorari should be granted.

Respectfully submitted,

CHARLES FAHY,
Solicitor General.

JULY, 1942.

CHESTER T. LANE,
General Counsel,
Securities and Exchange Commission.

APPENDIX

The pertinent provisions of the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 803, are as follows:

SECTION 1. (a) Public-utility holding companies and their subsidiary companies are affected with a national public interest in that, among other things, (1) their securities are widely marketed and distributed by means of the mails and instrumentalities of interstate commerce and are sold to a large number of investors in different States; * * *

(b) Upon the basis of facts disclosed by the reports of the Federal trade Commission * * * it is hereby declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected—

(1) when such investors cannot obtain the information necessary to appraise the financial position or earning power of the issuers, because of the absence of uniform standard accounts; when such securities are issued without the approval or consent of the States having jurisdiction over subsidiary public-utility companies; when such securities are issued upon the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties

and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies; when such securities are issued by a subsidiary public-utility company under circumstances which subject such company to the burden of supporting an overcapitalized structure and tend to prevent voluntary rate reductions;

* * * * *

(5) when in any other respect there is * * * lack of effective public regulation * * *.

(c) When abuses of the character above enumerated become persistent and widespread the holding company becomes an agency which, unless regulated, is injurious to investors, consumers, and the general public; and it is hereby declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section, connected with public-utility holding companies which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.

* * * * *

Section 6 (a):

SEC. 6. (a) Except in accordance with a declaration effective under section 7 and

with the order under such section permitting such declaration to become effective, it shall be unlawful for any registered holding company or subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly (1) to issue or sell any security of such company; or (2) to exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of such company.

* * * * *

Section 7 (a):

SEC. 7. (a) A registered holding company or subsidiary company thereof may file a declaration with the Commission, regarding any of the acts enumerated in subsection (a) of section 6, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. * * *

* * * * *

(b) A declaration filed under this section shall become effective within such reasonable period of time after the filing thereof as the Commission shall fix by rules and regulations or order, unless the Commission prior to the expiration of such period shall have issued an order to the declarant to show cause why such declaration should become effective. Within a reasonable time after an opportunity for hearing upon an order to show cause under this subsection, unless the declarant shall withdraw its declaration, the Commission shall enter an order either permitting such declaration to become effective as filed or amended, or refusing to permit

such declaration to become effective. Amendments to a declaration may be made upon such terms and conditions as the Commission may prescribe.

(c) The Commission shall not permit a declaration regarding the issue or sale of a security to become effective unless it finds that—

* * * * *

(d) If the requirements of subsections (c) and (g) are satisfied, the Commission shall permit a declaration regarding the issue or sale of a security to become effective unless the Commission finds that—

* * * * *

(6) the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers.

(e) If the requirements of subsection (g) are satisfied, the Commission shall permit a declaration to become effective regarding the exercise of a privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security unless the Commission finds that such exercise of such privilege or right will result in an unfair or inequitable distribution of voting power among holders of the securities of the declarant or is otherwise detrimental to the public interest or the interest of investors or consumers.

(f) Any order permitting a declaration to become effective may contain such terms and conditions as the Commission finds necessary to assure compliance with the conditions specified in this section.

Section 11 (b) (2):

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

* * * * *

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company.

Section 11 (e):

(e) In accordance with such rules and regulations or order as the Commission

may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of

the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

* * * * *

Section 17 (a) and (b):

SEC. 17. (a) Every person who is an officer or director of a registered holding company shall file with the Commission in such form as the Commission shall prescribe (1) at the time of the registration of such holding company, or within ten days after such person becomes an officer or director, a statement of the securities of such registered holding company or any subsidiary company thereof of which he is, directly or indirectly, the beneficial owner, and (2) within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, a statement of such ownership as of the close of such calendar month and of the changes in such ownership that have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company or any subsidiary company thereof, any profit realized by any such officer or director from any purchase and sale, or any sale and purchase, of any security of such registered holding company or any subsidiary company thereof within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the holding company or subsidiary company in respect of the security of which such profit was realized, irrespective of any in-

tention on the part of such officer or director in entering into such transaction to hold the security purchased or not to repurchase the security sold for a period of more than six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the company entitled thereto or by the owner of any security of such company in the name and in the behalf of such company if such company shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not cover any transaction where such person was not an officer or director at the times of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may, as necessary or appropriate in the public interest or for the protection of investors or consumers, exempt as not comprehended within the purpose of this subsection. Nothing in this subsection shall be construed to give a remedy in the case of any transaction in respect of which a remedy is given under subsection (b) of section 16 of the Securities Exchange Act of 1934.

* * * * *

Section 24 (a):

SEC. 24. (a) Any person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order in the circuit court of appeals of the United States within any circuit wherein such person resides or has his principal place of business, or in the United

States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. * * * The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. * * * The judgment and decree of the court affirming, modifying, or setting aside, in whole or in part, any such order of the Commission shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).

U. S. GOVERNMENT PRINTING OFFICE: 1948

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NOV 30 1942

No. 254

In the Supreme Court of the United States

OCTOBER TERM, 1942

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 254

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinions of the Court of Appeals (R. 139–155)[1] are reported in 128 F. (2d) 303. The Findings and Opinion of the Commission (R. 63–79, 115–132) are reported in 8 S. E. C. 893. The Sup-

[1] References to printed portions of the record before the Commission and to the record in the court below are designated by the symbol "R." References to the Commission's transcript certified to the court below, which by stipulation filed in this Court may be referred to in the briefs and upon the argument, are designated by the symbol "Tr."

plemental Findings and Opinion of the Commission (R. 104–113) and the Report of the Commission on a Plan of Reorganization (R. 97–104) are reported in S. E. C. Holding Company Act Release No. 3023.

JURISDICTION

The judgment of the Court of Appeals was entered April 27, 1942 (R. 155). The petition for a writ of certiorari was filed July 25, 1942, and was granted October 12, 1942 (R. 159). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, made applicable by Section 24 (a) of the Public Utility Holding Company Act of 1935.

QUESTION PRESENTED

Directors and officers of a registered holding company purchased preferred stock of the company during a period in which the management of the company, which they controlled, proposed to the Securities and Exchange Commission successive plans of reorganization pursuant to the Public Utility Holding Company Act of 1935. The Commission declined to approve a plan on the ground that the plan permitted the preferred stock so purchased to participate in the reorganization on a parity with all other preferred stock. Thereafter, the plan was amended to provide that the preferred stock so purchased, unlike the other

preferred stock, would not be converted into stock of the reorganized company, but might be surrendered to the reorganized company at cost plus interest. Over the objection of the directors and officers involved, the Commission approved the plan as amended.

The question is whether the Court of Appeals erred in reversing the Commission's order based upon the Commission's finding that it would be detrimental to the interests of investors and unfair and inequitable within the meaning of the Act to allow the preferred stock so purchased to participate in the reorganization on a parity with all other preferred stock..

STATUTE INVOLVED

The pertinent provisions of the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 803, are set forth in the Appendix, *infra*, pp. 47–55.

SPECIFICATION OF ERRORS

The court below erred:

(1) In failing to affirm the Commission's holding that the respondents were subject to fiduciary obligations which precluded them from profiting through trading in the securities of their corporation during the period of reorganization.

(2) In failing to affirm the Commission's determination that a plan of reorganization under which preferred stock so acquired by respondents would participate on a parity with all other pre-

ferred stock was detrimental to the interests of investors and unfair and inequitable within the meaning of the Act.

(3) In reversing the Commission's order approving a plan which allowed no participation to stock acquired by respondents during the period of reorganization, and required the surrender of such stock at cost plus four percent interest.

STATEMENT

Federal Water Service Corporation (hereinafter called Federal) was a registered holding company controlling subsidiaries which operated water, gas, electric and other properties in thirteen states and in one foreign country (Tr. 457-458). Federal registered as a holding company under the Public Utility Holding Company Act of 1935 on November 8, 1937 (R. 2).

Federal's capital structure.—At the time of its registration, Federal's capital structure (based upon a statement dated September 30, 1937) was, in summary, as follows (Tr. 41):

5½ Gold Debentures, due 1954		$6,898,500.00
Preferred stock, 159,269 shares	*$15,189,639.75	
Class A stock, 568,775 shares	*13,998,733.50	
Class B stock, 542,450 shares	*2,500,000.00	
Total capital stock		31,356,373.25

*All without par value; shown at stated values.

The preferred shares had dividend and liquidation preferences over the Class A and Class B shares and the Class A shares had comparable

preferences over the Class B shares (Tr. 4–5). The Class B shares had the entire voting power except in respect of the creation of liens, the issuance of prior preferred shares, and the election of three of the seven directors (Tr. 5, 17–19).

From 1932 through 1935 the company's income had been less than its interest charges and expenses (Tr. 47, 49–51).[2] Annual dividend requirements on the preferred stock aggregated about $1,000,000, and on the Class A, approximately $1,137,000 (Tr. 4–5). No dividends had been paid on any class of stock since 1931 (Tr. 615). At November 7, 1937, dividend arrearages on the preferred stock amounted to nearly $6,000,000, while arrearages on the Class A stock totalled approximately $7,000,000 (Tr. 4–5, 41).

As of September 30, 1937, Federal's books disclosed a deficit in its surplus account in an amount equal to approximately half the stated value of its Class B stock (Tr. 9, 41–43). In addition, financial statements filed with the Commission showed the fair value of Federal's investments to be at least[3] $5,000,000 less than the $35,477,170

[2] These figures are on a corporate basis and do not take into account undistributed income in the hands of subsidiaries (Tr. 47, 49–51; R. 101).

[3] A then-current appraisal prepared by appraisers selected by Federal indicated that the fair value of Federal's investments was fully $10,000,000 below carrying value, of which sum only $5,000,000 was reflected in the financial statements (Tr. 41–43; 92–95).

carrying value (Tr. 41–43). If this diminution of value had been fully reflected on the corporate books, there would have resulted a deficit in excess of the stated capital applicable to the Class B stock (Tr. 9, 41–43).

The respondents' plans.—Even before Federal registered under the Act, its management recognized the need for reorganization (Tr. 10–11; R. 118). As the Commission found (R. 117), there were two incentives to reorganization. The primary incentive lay in Federal's deficits, for the Delaware law prohibited payment of dividends on any class of stock as long as the capital represented by stock having a preference on distribution of assets was impaired (R. 117).[4] Another incentive was found to exist in the fact that Federal's capital structure was plainly such as to confront Federal with the prospect of compulsory simplification under Section 11 (b) (2) of the Public Utility Holding Company Act unless it could succeed in thoroughly revamping its structure by some other permissible method (R. 118).

Accordingly, as soon as Federal registered on November 8, 1937, it immediately voluntarily submitted a plan of readjustment to the Commission in the form of a proposal, described more fully hereafter, to exercise a "privilege or right to alter the priorities, preferences, voting power, or other rights of the holders" of its outstanding classes

[4] Del. Rev. Code (1935) § 2066.

of stock, within the meaning of Section 6 (a) (2) of the Act (Tr. 1–15). After the initial plan, three other plans were successively filed by Federal (R. 118).[5] The plans were filed as declarations under Section 7 of the Act, requiring the Commission's consideration of whether it was "detrimental to the * * * interest of investors" within the meaning of Section 7 (e). The Commission, without objection by respond-

[5] The management's vacillations with respect to plans appear to have been due in part to problems assumed to exist under Delaware law (R. 3; Tr. 10–11, 493–497, 789, 3226–3246). At one time, doubt was expressed whether, under Delaware law, it would be possible to satisfy the preferred stockholders' claims, including dividend arrears, through issuance of a single class of new common stock, if any participation should be allowed to the holders of the Class A or Class B stocks (R. 3, 19–20). (See *Keller* v. *Wilson & Company*, 190 Atl. 115 (Del. 1936); *Consolidated Film Industries, Inc.* v. *Johnson*, 197 Atl. 489 (Del. 1937); *Havender* v. *Federal United Corporation*, 6 A. (2d) 618 (Del. 1939)). Subsequently, the case of *Havender* v. *Federal United Corporation*, 11 A. (2d) 331 (Del. 1940), indicated that the obstacles to a one-stock recapitalization under Delaware law would not apply if the transaction took the form of a statutory merger. Federal's fourth plan was designed to conform to the procedure suggested by the *Havender* case (R. 19–20). Because of alleged doubts as to the constitutionality of Section 11 (e) of the Act, the company did not seek to avail itself of the reorganization machinery of that Section (R. 43–44; Tr. 1905–1906) whereby the Commission may apply to a federal equity court to enforce a plan without the consents required by state law if the plan is found fair and equitable and necessary to effectuate the provisions of Section 11 (b), and if the company requests such enforcement. When Federal's plans were filed, there existed no judicial precedent for the enforcement of a plan approved

ents, also considered (R. 129, 132) the proposals as embodying plans under Section 11 (e) to eliminate undue complexities as required by Section 11 (b) (2) of the Act. Accordingly, in passing on the proposal, the Commission considered it in the light of standards of both Sections 7 (c) and 11 (e).

Throughout the four years during which its plans were pending the management of Federal, whose interests were originally identified primarily with the Class B stock (R. 14), sought to perpetuate the strategic advantages inherent in the dominant voting power of the Class B stock, although there was no equity for that class (R. 101–102, 118) and very little for the Class A stock (R. 101–102, 118). Their efforts followed three main courses: (1) to consummate a plan of recapitalization which would allot substantial participation to the Class B stock (Tr. 1, 5–6, 13; 459–465; 487, 499–504); (2) to re-elect the incumbent directors for long and "staggered" terms (Tr. 520–522; R. 122); and (3) to acquire pre-

by the Commission under Section 11 (e). The constitutionality of Section 11 (e) was not judicially determined until June 15, 1940, in *In re Community Power & Light Co.*, 33 F. Supp. 901 (S. D. N. Y.). Federal itself reserved the right to challenge the constitutionality of all provisions of the Act except the registration provisions (see *e. g.*, Tr. 26, 516, 794, 1905–1906, 3220–3221). Under the company's self-imposed limitations, the plan could be accomplished only by charter amendments and other devices provided by the laws of Delaware.

ferred stock for the purpose of preserving their own dominant position in the event the Class B stock should ultimately be eliminated (R. 14–15; 23). The last mentioned course, described more fully below (pp. 12–14), is the one in issue here.

In order to accomplish a recapitalization, Federal proposed plans which fell within two general categories. The first category consisted of a plan only to remove, by means of a so-called "accounting reorganization," the existing and potential deficit in order to cure the obstacle against payment of dividends (R. 19; Tr. 459–465, 3150–3160). This type of plan embodied proposed reductions in the stated capital applicable to the various classes of stock (Tr. 3153), the creation by this means of a new capital surplus (Tr. 3164), and the use of the capital surplus so created to absorb the deficits (Tr. 3164). This method left untouched existing voting rights, liquidation rights, and dividend accumulations (Tr. 3166), and did nothing to remove the complexity of the capital structure or the top-heavy burden of current dividend requirements (R. 18–19). It left the worthless Class B stock with substantially unimpaired position (Tr. 464), and did not advance the objective of bringing the complex capital structure and unfair distribution of voting power into compliance with Section 11 (b) (2) of the Act (R. 117–118).

The other category of plan advanced by Federal, involving the submission of three separate proposals (Tr. 1–15; 487–523; 782–800), provided for a recapitalization which would remove dividend accumulations and create new stock in place of the outstanding preferred and Class A stocks (Tr. 6, 496–504, 786–788). This type, in its earlier forms, retained for the worthless Class B stock an interest in the company either through option warrants or through "special stock" having voting power and exchange features similar to option warrants (Tr. 12–16, 499, 502–504). In addition, the third and fourth plans proposed to insure the continued control of the system by Federal's management through the device of electing the existing directorate for "staggered" terms (Tr. 521–523, 798–799; R. 21).

At various times, all of these plans were the subject of discussions with the Commission's staff and of formal administrative hearings (Tr. 1356–3043, 3437–3499; R. 3). On May 19, 1938, while the first plan was pending, the second plan was formally filed for consideration in the event the Commission should not approve the first plan (Tr. 3151–3152). On May 11, 1939, a third plan was presented (Tr. 487–523). On August 26, 1939, the first and third plans were withdrawn, leaving only the second—a capital reduction type of plan—before the Commission (Tr. 753). The

fourth and final plan was not filed until March 30, 1940 (Tr. 782–800).*

This plan proposed the merger of Federal, Utility Operators Company (see *infra*, p. 12) and Federal Water and Gas Corporation into Federal, the surviving corporation, which was to change its name to that of its subsidiary, Federal Water and Gas Corporation (R. 20, 119–122).† The preferred and Class A shares of Federal were to be converted into 1,058,268 common shares of the surviving corporation, of which about 95% was to be issued to the preferred stockholders and 5% to the Class A stockholders (R. 119–120). The Class B stock was to receive nothing (R. 120), but a "staggered board" provision was inserted for the express purpose of preserving the existing management for a period (R. 21, 122) as the price of surrender of the Class B stock (Tr. 2505–2507). In the merger,

* By March 30, 1940, there had been no improvement in the financial condition of Federal. The balance sheet on December 31, 1939, stated the total assets at $29,915,729, of which investments comprised $23,836,361, a figure the management itself regarded as excessive. In addition, there were intangible items of nearly $2,000,000, which were to be written off. The earned surplus deficit had increased to $3,865,070 and there was a capital surplus deficit of $3,848,865. Dividend accumulations on the preferred stock had increased to $8,259,042 and on the Class A stock to $9,479,583. (R. 70; Tr. 828–829, 835.)

† Federal Water and Gas Corporation, hereinafter called "Federal Gas," was a wholly owned subsidiary of Federal. It had no important assets, and existed to preserve its corporate name for Federal (R. 64; Tr. 1129).

the outstanding stock of Utility Operators Company (hereinafter called Operators), of which respondents held about one-third (Tr. 581–584), was to be exchanged for approximately 41,500 shares of the new common stock, which represented the value of the Federal preferred stock, debentures and other assets held by Operators (R. 120).

Under this plan respondents would have been permitted to participate in the plan with respect to all preferred stock held by them directly or through Operators on the effective date of the plan (R. 119–121, 124).

Respondents' relation to Federal and their purchases of stock.—All of Federal's Class B stock and about 6,500 shares of preferred stock were owned by Operators (Tr. 14). Operators was also a registered holding company. Its assets consisted of this stock of Federal, a few debentures of Federal, and a small amount of miscellaneous items (R. 115). The individual respondents and C. T. Chenery, who controlled the respondent Chenery Corporation, were officers or directors of Federal or its subsidiaries and were also officers, directors, and principal stockholders of Operators (Tr. 14, 17–19, 1171–1172; R. 86–87). The Class B stock, being a unified voting block, controlled Federal, even though by virtue of dividend defaults the Class A stock had acquired 44.80% of

the voting power and the preferred stock had acquired 12.4% (Tr. 15).[4]

During the period from November 8, 1937, to June 30, 1940, when Federal's several plans were on file or under discussion, and when it was apparent that the Commission's staff would oppose participation of Class B stock, the respondents purchased a total of 12,407 shares of Federal's preferred stock (Tr. 71–72). Most of these shares were purchased on the over-the-counter market at prices which were below the book value of the common stock of the surviving corporation into which they would have been converted (R. 124). The relative importance of the stock held by respondents which was purchased subsequent to November 8, 1937 (R. 57–60), is shown as follows (figures are approximate):

Name	Number of shares of Federal's preferred (150,000 outstanding)	Number of shares of surviving company to be received in exchange	Percentage of shares of surviving company (1,050,000 to be issued)
Preferred stock owned by respondents before 11/8/37:			
Respondents' holdings in other preferred shares owned by Quintuplex			2.7+%
Preferred stock purchased by respondents after 11/8/37			4.1+%
			10.4%

[4] There were about 6,000 preferred stockholders and 10,000 Class A stockholders (Tr. 1557).

The 12,500 share block had been deliberately acquired in the light of views expressed by the Commission's staff concerning the impropriety of participation for the Class B stock and for the avowed purpose of preserving the respondents' interest in and control of Federal even though they might lose the Class B stock (R. 14–15, 23–24). The purchases were reported by respondents pursuant to Section 17 of the Act (R. 17–18). The Commission found that after individual stockholders had complained of respondents' purchases, the officers and directors agreed upon a policy of deferring individual purchases while particular plans were in contemplation but had not been made public (R. 125).[9] The Commission made no finding of fraud or concealment of information (R. 124–125).

The Commission's determinations.—On March 24, 1941, the Commission, after hearings and argument, promulgated its findings and opinion, which "for the present" (R. 130) denied effectiveness to the fourth plan on the ground, so far as here material,[10] that participation of the preferred shares acquired by respondents after November 8, 1937,

[9] The Commission found that "an honest effort appears to have been made to adhere to this policy" (R. 125).

[10] The Commission also disapproved the "staggered board" provision as an attempt to perpetuate the position of the Class B stock which was found to be without equity (R. 130–131). The Commission found further that the par value of the common stock to be issued was fixed at too high a figure. These determinations are not in issue here.

on a basis of equality with the other preferred shares of Federal would make the terms of issuance of the new stock "detrimental to the interests of investors," under Section 7 of the Act, and the plan "unfair and inequitable," under Section 11 (e) (R. 129, 132).[11] The Commission, however, withheld for 30 days entry of an order refusing to permit the declaration to become effective, stating that it would further consider the matter if Federal meanwhile filed amendments to cure the defects in its plan (R. 131).

On July 1, and August 12, 1941, after further informal discussions between the Commission's staff and the management, Federal filed amendments to the plan of merger in response to this suggestion (Tr. 1030, 1046). The amendments included provisions (to which respondents agreed subject to a reservation of any right they might have to review the Commission's action) that (a) no stock in the surviving corporation should be issued for the preferred shares acquired by respondents after November 8, 1937; and (b) respondents would surrender the stock to the surviving corporation at cost plus 4% inter-

[11] A majority of the Commission approved the general framework of the plan, Commissioner Healy dissenting with respect to the participation accorded the Class A stock. That question is not, however, involved in the present proceeding, and the Commission was unanimous in holding that in view of the respondents' participation under the plan disapproval would be required unless corrective amendments were filed (R. 115–132).

est, less all profits made by respondents on any sales thereof (R. 80–85).

Following the filing of these amendments, the Commission permitted the respondents to intervene (R. 96–97). They filed a pleading and briefs requesting the Commission to reconsider the case and to deny effectiveness to the amended plan unless modified to allow the preferred stock in question to participate in the reorganization on a parity with the other preferred stock (R. 85–95, 104–105). On September 24, 1941, the Commission issued a report on the amended plan (R. 97–103), and Supplemental Findings and Opinion adhering to the views expressed in its earlier opinion (R. 108) and approving the amended plan (R. 104–111). By order of the same date, the Commission permitted the declarations embodying the amended plan to become effective forthwith subject to conditions which are not now important (R. 112–113).

On review of the Commission's order, in which respondents raised only the issue now involved (R. 1–10), the Court of Appeals, Justice Miller dissenting, reversed the Commission's order and remanded the cause for further proceedings in accordance with the court's opinion (R. 139–155).

SUMMARY OF ARGUMENT

The issue before the Commission was whether it would be "fair and equitable" and not "detrimen-

tal to the public interest or the interest of investors" to permit respondents, who in the course of the four years during which reorganization had been pending had attempted by varying methods to retain their control of Federal, to participate as to stock acquired by them during the pendency of the reorganization on a parity with all other stock of the same class. The Commission's determination that it would not be fair and equitable and that it would be detrimental to the interests required to be protected is soundly based upon applicable principles relating to fiduciaries and is consistent with the statutory standards.

The respondents, as officers, directors and controlling stockholders, had substantial powers over the reorganization of Federal under the Act. Through the exercise or non-exercise of those powers, respondents could affect extensively the rights and interests of all the stockholders in the corporation. These circumstances warranted the Commission in imposing upon respondents fiduciary obligations to Federal and its stockholders, comparable to those borne by "reorganization managers" and "protective committees" in judicial reorganization proceedings. Applicable principles of equity, therefore, furnished the basis for precluding respondents from acquiring for profit securities of Federal while they were engaged in formulating and proposing plans of reorganiza-

tion. Neither a director's liability to stockholders in the ordinary buying and selling of corporate securities nor the security trading provisions of Section 17(b) of the Act relieved respondents from their fiduciary obligation to all of the stockholders in connection with the plan. On the contrary, the broad standards of Sections 7 and 11, and the legislative history of those sections, plainly establish that Congress intended to vest the Commission with powers in situations like the present at least equal to those powers which inhere in bankruptcy courts and under which such courts have imposed obligations analogous to the obligations here imposed by the Commission.

ARGUMENT

THE COMMISSION PROPERLY LIMITED RESPONDENTS' PARTICIPATION IN RESPECT OF SECURITIES PURCHASED BY THEM IN THE COURSE OF THE REORGANIZATION

Between 1937 and 1940, in recognition of the need for Federal's reorganization, Federal, Operators, and their subsidiary, Federal Water and Gas Corporation, filed applications and declarations with the Securities and Exchange Commission which in their ultimate form were designed to effect a readjustment of the rights of Federal's stockholders by merger of Federal with the other two corporations. In all, four separate plans, several times amended, were advanced.

In these proposals, respondents played the major role. Directors, officers and principal stockholders of Operators, respondents were also offi-

cers or directors of Federal or its subsidiaries. Through Operators' holdings of Class B stock, comprising a unified voting block, respondents controlled Federal. Their discussions with the Commission's staff and hearings before the Commission's trial examiners made it apparent to respondents that a major obstacle to the Commission's approval of the declarations and plans lay in the provisions for participation of the Class B stock controlled by respondents. Nevertheless, throughout the four year period, respondents placed before the Commission plans which, in varying forms and by varying methods, proposed to perpetuate respondents' control over Federal by assuring survival of that control after readjustment.

Initially, respondents' plans to achieve this objective took the form of proposed recapitalizations which would permit significant participation to the Class B stock, and of proposed reelection of the incumbent directors for long and staggered terms (*supra*, p. 10). Meanwhile, respondents acquired preferred stock for the express and admitted purpose of insuring their personal interests and their enduring control in the event of the ultimate elimination of the Class B stock.[12] Finally, in 1940, after respondents had purchased substantial amounts of the preferred stock, Federal filed its fourth plan, by which

[12] C. T. Chenery, president of Federal, testified (R. 14–15): As long as we thought that a plan would be worked

for the first time the Class B stock was to receive nothing, but the preferred and Class A stock of Federal were to be converted into common shares of the corporation surviving the proposed merger. Under this proposal, respondents through their direct and indirect holdings of Federal's preferred stock would have owned somewhat more than 10 per cent of the shares of the surviving company.[15]

It was in these circumstances that the Commission was faced with the issue whether to approve respondents' fourth and final plan which thus

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out which would give the B Stock an opportunity to come back in the future, my suggestion was to those stockholders and I think I testified to this effect at the first hearing here in 1937 that they should save so that at the expiration or at the end of the period, they would be in a position to exercise the option and acquire that stock. Then when it became apparent that this was not to be, a meeting was held of the B stockholders and it was their decision that they would contest any plan which worked them out completely and the suggestion was made that it would be wise to purchase such preferred stock as they reasonably could so that in the event that there was litigation and the plan was not worked out and that finally it should be held that the B stock was not entitled to anything, that these men who had held this Corporation together and who were its loyal servants would still have some position in the Corporation, some voice.

[15] The significance of the proposed holdings of respondents in the surviving corporation is underscored by Section 2 (a) (7) (A) of the Act, in which Congress has defined a holding company to include a company which owns or con-

would have permitted perpetuation of respondents' control. In resolving this issue, the Commission was required [14] by paragraphs (d) (6) and (e) of Section 7 of the Act (Appendix, *infra*, p. 50) to determine whether the proposed alteration of the rights of Federal's security holders would be "detrimental to the public interest or the interest of investors or consumers". In addition, although the declarations had been filed under Section 7, Federal plainly and admittedly was in need of reorganization or recapitalization in the light of its complex structure, its financial condition, and its inequitable distribution of voting power (*supra*, pp. 4–7). Federal's declara-

trols 10 per cent or more of the voting stock of another company. Congress has thus recognized the potential power of a closely held 10 per cent of voting stock. And it should be noted that the remaining voting power would have been widely scattered among some 16,080 preferred and Class A stockholders of Federal (Tr. 1597).

The fourth plan also proposed the continuation in office of the incumbent directors (R. 122).

[14] Section 6 (a) (Appendix, *infra*, p. 49) prohibits registered holding companies from issuing or selling securities and from altering the rights of outstanding securities, except, in so far as here material, in accordance with effective declarations filed with the Commission by such companies under Section 7. Paragraph (f) of Section 7 empowers the Commission to attach to its order permitting declarations to become effective such terms and conditions as it finds necessary to assure compliance with the standards specified in Section 7.

The technical issue before the Commission was whether to permit the declaration to become effective.

tions embodying the various plans looked toward reorganization and capitalization to meet the requirements of Section 11. And accordingly, it was necessary for the Commission to test the plan not only by the standards of Section 7, but also by the standards, embodied in Section 11 (e) (Appendix, *infra*, pp. 52–53) that the plan be "necessary to effectuate the provisions of subsection (b)"[15] and be "fair and equitable" to the persons affected."[16]

The issue before the Commission, acting as an administrative agency under these broad stand-

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[15] Section 11 (b) (2) of the Act (Appendix, *infra*, pp. 51–52) requires the Commission to order registered holding companies and their subsidiaries to take such steps as the Commission finds necessary to insure that the structure of holding companies does not unduly or unnecessarily complicate the structure of the holding company system or that voting power is not unfairly or inequitably distributed among security holders. Subsection (e) (Appendix, *infra*, pp. 52–53) permits any registered holding company or subsidiary to submit a plan to the Commission for the purpose of enabling such company to comply with the provisions of subsection (b).

[16] Respondents did not question, either before the Commission or before the court below, the Commission's holding (R. 122–123, 131–132) that the standards of Section 11 were applicable to the proceedings. On the contrary, in their petition for review in the court below, respondents affirmatively urged that the Commission's order was "unfair and inequitable" (R. 8). Similarly, before the Commission respondents contended that approval of the fourth plan as amended in accordance with the opinion of March 24, 1941 (*supra*, pp. 14–15), would be "unfair" and "inequitable" (R. 93).

ards of the Act was, therefore, whether a plan, which permitted the securities acquired by respondents during the four years' pendency of the reorganization which they had initiated, was "detrimental to the public interest or the interest of investors or consumers", and, by comparable standards, not "fair and equitable."[11] In exercising its duty to resolve this issue under the standards of the Act, the Commission necessarily turned to such relevant analogies as the rules enunciated by Congress and by the courts dealing with the contents of the clause "fair and equitable" in related fields (R. 125–132). In the light of all available experience and authority, the Commission concluded that, notwithstanding the normal right of management freely to deal in securities and to enjoy the full fruits of such dealing, it would be inconsistent with the standards of the Act to permit securities acquired by management pending and in contemplation of this reorganization to participate in the reorganization

[11] Technically, the question before the Commission was the converse: After the plan had been amended to conform to the Commission's opinion of March 24, 1941, the issue was whether the declaration thus *eliminating* respondents' newly acquired holdings from participation (subject to a right to surrender them for cost plus 4 per cent interest) should become effective as not detrimental to the public interest and the interest of investors and whether the plan, embodying such elimination, was fair and equitable. But the issue in the proceeding for review has been more realistically treated as stated in the text.

on an equal basis with other securities not so acquired.

A majority of the court below posed the issue as turning upon the question "whether there is any statute, regulation, or rule of common law or equity which proscribes" the respondents' security transactions during reorganization (R. 143). Since the majority found no such statute, regulation, or rule, it concluded that the Commission's findings and determination were unauthorized by the Act, that the Commission had made a policy determination open only to Congress, and that the order was therefore invalid (R. 139–150). We submit that the court below was in error in thus posing the issue. The issue was, rather, whether the Commission could properly conclude that it would be "detrimental to the public interest or the interest of investors" and that it would be unfair and inequitable to permit the securities acquired by respondents while reorganization was pending to participate equally with others in the reorganization. We urge that the Commission's resolution of this question is in accord with current legislative and judicial concepts of management's obligations in analogous fields and is, under the same analogies fixing the elements of what is "fair and equitable," wholly consistent with the statutory standards which the Commission was required to apply. If this be so, as we submit it is, the Commission was free to adopt the princi-

ple, and since its determination was reasonable, it should not have been overturned by the court below. *United States* v. *Lowden*, 308 U. S. 225, 231, and cases cited; *Gray* v. *Powell*, 314 U. S. 402.[18]

Respondents' fiduciary position and obligations.—The Commission, in applying the statutory standards to the declarations and plans before it, adopted guides from analogous fields where fiduciary relationships are found to exist and fiduciary obligations are imposed. It concluded that, in the circumstances presented by the case, respondents' position and powers in the reorganization were such as to require their treatment as fiduciaries;[19] it concluded also that, since respond-

[18] See also *Federal Trade Commission* v. *Keppel & Bro., Inc.*, 291 U. S. 304, 314; *Federal Radio Commission* v. *Nelson Brothers Bond & Mortgage Co.*, 289 U. S. 266; *United States ex rel. Ness* v. *Fisher*, 223 U. S. 683; Note (1942) 56 Harv. L. Rev. 126, 130.

[19] Chenery Corporation stands in the same position as the individual respondents. It is a family holding company, controlled by C. T. Chenery, the president of Federal and of Operators (R. 13), and the Federal securities purchased by it were acquired under his direction (R. 13, 23, 24). Applicable to its participation is the rule that "one who knowingly joins a fiduciary in an enterprise where the personal interest of the latter is or may be antagonistic to his trust becomes jointly and severally liable with him for the profits of the enterprise." *Irving Trust Co.* v. *Deutsch*, 73 F. (2d) 121, 125 (C. C. A. 2), certiorari denied *sub nom. Bell* v. *Irving Trust Co.*, 294 U. S. 709; *Jackson* v. *Smith*, 254 U. S. 586. The Commission treated Chenery Corporation as in the same position as the other respondents, and no error has been assigned in respect of this treatment.

ents should be treated as fiduciaries, the principles developed and established by Congress and the courts restricting fiduciaries who hold positions and powers similar to those of respondents should be imported into the instant situation. (R. 107–108, 124–129, 132.) Accordingly, it permitted the declarations to become effective only after the plans eliminated opportunity for profit from participation of stock acquired by respondents in the course of reorganization.

The propriety of the Commission's treatment of respondents, managers of Federal, as fiduciaries, is apparent from analysis of the powers vested in them by the Act in respect of reorganization proceedings. By the relevant provisions of the Act Congress vested in the management of a holding company sweeping powers to represent all the stockholders in formulating, initiating and effecting a plan of reorganization.

Primarily, it should be noted that management has significant powers in initiating and timing action looking toward reorganization under the Act. Only the Commission (Section 11 (b) (2), Appendix, *infra*, pp. 51–52) and the holding company itself (Section 11 (e), Appendix, *infra*, pp. 52–53) may initiate action under the Act for the purpose of simplification of corporate structures and of fair and equitable distribution of voting power among security holders. No provision is made in Section 11 (b) or (e) for the

institution of proceedings other than by the Commission or the company itself.[20]

The powers of management to initiate and time reorganizations were particularly significant during the period here in question; over a substantial portion of the period, these powers rested in the hands of management to the exclusion even of the Commission. Section 11 (b) permitted the Commission to proceed on its own motion only after January 1, 1938, while under Section 11 (e) the machinery for accomplishing reorganization and other action to comply with Section 11 (b) was available to the managements of registered holding companies at any time after January 1, 1936. Management thus enjoyed the sole power for two years. And, as a practical matter, this two-year period was substantially extended.[21] The Commission's publicly

[20] See *Republic Service Corp.*, Holding Company Act Release No. 3513 (May 9, 1942), in which the Commission held that an individual preferred stockholder could not file a plan of reorganization under Section 11 (e). In cases where a proceeding is instituted by the Commission under Section 11 (b) and application is made to a court under Section 11 (d) to enforce the Commission's order, the plan may be proposed by the Commission or by any person having a *bona fide* interest in the reorganization.

[21] It was not until after the decision of this Court in *Electric Bond & Share Co.* v. *Securities and Exchange Commission*, 303 U. S. 419 (decided March 28, 1938), that there was general compliance with the registration provisions of the Act. Federal registered on November 8, 1937, the day on which *Electric Bond & Share Co.* v. *Securities and Exchange Commission*, 92 F. (2d) 580 (C. C. A. 2), was decided.

announced policy was to allow an additional period for voluntary compliance before instituting proceedings to enforce compliance with Section 11. The Commission's Annual Report for the fiscal year ended June 30, 1938, transmitted to Congress on January 3, 1939, stated at page 10:

> It will be realized that the problem of conforming the electric and gas utilities to the requirements of Section 11 (b) is a task of great magnitude. Its most expeditious accomplishment turns upon the willingness of the industry voluntarily to take the necessary steps. The Commission's policy has been and is to give each holding company every reasonable opportunity to effectuate the Section 11 (b) programs by voluntary proceedings, and to institute involuntary proceedings under Section 11 (b) only as a last resort or where the exigencies of special situations make such a course desirable or necessary.[22]

[22] In the Commission's Report there appeared the following footnote to the above-quoted statement:

> On May 5, 1938, a Committee of Holding Company Executives was chosen by 14 major utility systems for the purpose of conferring with the Commission from time to time on these and other problems arising under the Public Utility Holding Company Act of 1935. On August 3, 1938, Chairman Douglas addressed a letter to the heads of all registered holding companies requesting the various systems to present, not later than December 1, 1938, tentative suggestions and programs looking toward compliance with Sections 11 (b) (1) and 11 (b) (2) of the Public Utility Holding Company Act of 1935.

In pursuance of this policy, it was not until the spring of 1940 that the Commission instituted enforcement proceedings against the major holding company systems. Until that time, management alone controlled the initiation of proceedings.[23]

Management power also extends to other important elements of the reorganization proceedings. It has control as well over the development of the action. Thus, under Sections 7 and 11 (e) only the management may amend the plan, and it may do so at any time; only the management may withdraw the plan, and this too it may do at any time; and the management may conclude not to carry it out even after Commission approval.

This type of reorganization procedure, therefore, in contrast to the procedure prescribed by

[23] It is clear that the Commission was intended by Congress to initiate action only after other possibilities had been exhausted. Thus it was stated in the Report of the National Power Policy Committee, which was annexed to the report of the Senate Committee on Interstate Commerce approving an earlier draft of the Act, that (S. Rep. No. 621, 74th Cong., 1st Sess. (1935), pp. 58, 60):

> Furthermore, it seems administratively advisable that every opportunity be offered the owners of holding-company securities to work out their own processes of dismantling * * *.
>
> * * * * * * *
>
> * * * Voluntary action by the companies should be encouraged as much as possible, but the commission should be empowered to issue orders compelling necessary divestments, dissolutions, and reorganizations. * * * *

Chapter X of the Bankruptcy Act, places essential power in the hands of management rather than of security holders. If it were not safeguarded by appropriate administrative procedures, the procedure would involve the dangers of a "short receivership" or a "management plan,"[24] rather than a judicially supervised reorganization. In these circumstances management, having so large a measure of control, may reasonably be charged with the duty to represent all classes of security holders and to come forward with and develop a plan fair to all. When management is vested with such significant control, and so solemn a duty of representation, management trading in the securities involved in the reorganization inevitably and at the very least creates problems of divided loyalties. In such reorganizations, it is in the power of management to formulate, present and withdraw plans, to time the submission of plans and the filing of amendments, and to have access, through negotiations with the Commission, to information not available to the security holders regarding the future course and probable result of proceedings. With these powers management can, through dealing in the securities, realize profits and dispose of those securities most likely to be valueless as a result of the reorganization, or—as occurred here—acquire for its own benefit those securities likely to survive and to possess voting control.

[24] See S. E. C. Protective Committee Study, Part VIII, pp. 318–322; Part VII, *passim;* Part I, p. 312 ff.

Thus, the position of the management of a holding company during the pendency of reorganization proceedings under the Act is analogous to the position of a protective committee or of reorganization managers who undertake to initiate and evolve a plan of reorganization. See *infra*, p. 44, note 37. They are fiduciaries because of their power to act in the reorganization proceeding on behalf of the security holders. *In re Republic Gas Corp.*, 35 F. Supp. 300 (S. D. N. Y.); *In re Paramount-Publix Corp.*, 12 F. Supp. 823, 828 (S. D. N. Y.), affirmed, 83 F. (2d) 1015 (C. C. A. 2); see *American Ins. Co.* v. *Avon Park*, 311 U. S. 138, 147. And, indeed, the power of officers and directors over a "voluntary reorganization" like the one here involved is even broader than that of a protective committee in a typical judicial reorganization. A protective committee's control of a judicial reorganization under the Bankruptcy Act is limited by the fact that individual security holders have the right to initiate such proceedings. Management or protective committee control in such reorganization is further curtailed by the typical emergence of new leaders, such as indenture trustees or court-appointed trustees. Here, in contrast (as has been noted *supra*, pp. 26–29), the management controlled the proceeding, subject only to the power of the Commission to disapprove the plan, to impose conditions upon approval, or to propose a plan at a later time as a means of en-

forcing an order entered in a proceeding instituted by it under Section 11 (b) of the Act.[28] The strategic position enjoyed by the management in this type of reorganization proceeding and the vesting in it of statutory powers available to no other representative of security holders plainly warrant the Commission's treating respondents as fiduciaries obliged to observe at least the higher standard of conduct required of members of protective committees. *Cf. Woods* v. *City Bank Co.*, 312 U. S. 262, 268.[29]

Admittedly, as held below (R. 143–144), directors and officers, by the weight of authority, are not fiduciaries for the individual stockholders in their day-to-day purchases and sales of corporate stock. But that rule has no relevance here, for in such a

[28] The Commission's current practice is to institute cross-proceedings under Section 11 (b) and to consolidate hearings on the cross-proceedings with the hearing on a plan under Section 11 (e). However, even under this practice, which had not been developed at the time of the instant proceedings, the management enjoys considerable strategic advantage with reference to the timing of reorganization.

[29] A majority of the court below, however, held (R. 147) that the principles relating to protective committees could not be applied here by the Commission since respondents, in contrast to protective committees, did not act under a deposit agreement or other written instrument, or an express trust. But the fiduciary obligations of members of protective committees to the security holders they undertake to represent are not dependent upon the existence of an express trust or upon the deposit of securities with the members. *United States* v. *Buckner*, 108 F. (2d) 921, 926–927 (C. C. A. 2), certiorari denied, 309 U. S. 669; see Note (1936) 46 Yale L. J. 143, 145.

case as this the effect of trading by management is not measured by the fairness of individual transactions between buyer and seller, but by its relation to the timing and dynamics of the reorganization which the management itself initiates and so largely controls.

The court below also held (R. 148) that the Commission's treatment of respondents as fiduciaries was erroneous since even after Commission approval of the plan, its consummation would still be subject to a vote of stockholders and to conformance with state law. Participation by others plainly cannot free respondents from responsibility for their activities. The mere fact that some other body or group will pass on the plan cannot justify disregard of fiduciary responsibilities; if it could, there would be no basis for judicial and legislative restrictions upon security trading by reorganization managers and protective committees in judicial reorganization proceedings. Moreover, the reasoning of the court below completely overlooks the prejudice to security if antagonistic trading interests of the management should lead it to delay the presentation of an adequate plan."

" Thus it has been held that corporate managers, under certain circumstances, owe a duty to stockholders to institute proceedings for the dissolution of the corporation and are accountable to the stockholders and the corporation as fiduciaries for personal gains and emoluments during the period in which they have delayed and refused to institute such pro-

The facts relating to respondents' power and position in connection with the reorganization proceedings were, therefore, at least as compelling as the facts which underlie judicial treatment of those with similar power and position as fiduciaries in comparable situations." Accordingly, the remaining question before the Commission was what obligations flow from respondents' fiduciary relationship. The Commission, as we have noted (*supra*, pp. 25–26), looked to legislative and judicial analogies in related fields for guides in determining the content of the standards of fairness and equity, and of action in the public interest and in the interest of investors. These analogies, applicable because of respondents' positions as fiduciaries, warranted the Commission in finding that participation of holdings acquired by respondents

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ceedings. *Kroger* v. *Jaburg*, 231 App. Div. 641, 248 N. Y. S. 387 (1st Dept. 1931); *Miner* v. *Belle Isle Ice Co.*, 93 Mich. 97, 53 N. W. 218 (1892). Cf. *Tower Hill-Connellsville Coke Co.* v. *Piedmont Coal Co.*, 64 F. (2d) 817 (C. C. A. 4), certiorari denied, 290 U. S. 675.

[11] The Commission's action here was far less drastic than that prescribed by this Court in *Taylor* v. *Standard Gas & Electric Company*, 306 U. S. 307, in which this Court held that a debt claim of a controlling stockholder which had organized a corporation with a top-heavy and insufficient capitalization, and which had been guilty of other mismanagement, should be subordinated to publicly held preferred stock. In this case the respondents although not found to be responsible for creating the financial difficulties confronting the company were in control at a time when the company was in need of reorganization to cure a capital structure which had proved to be top-heavy. Before going forward

during reorganization did not satisfy the standards of Sections 7 and 11 of the Act.

It has long been settled that, in order to minimize dangers of divided loyalties implicit in such transactions, a trustee is prohibited under equity principles from purchasing property embraced by the trust "though he has done so for a fair price, without fraud, at a public sale." *Michoud* v. *Girod*, 4 How. 502, 557 (1846); *Magruder* v. *Drury*, 235 U. S. 106; *Meinhard* v. *Salmon*, 249 N. Y. 458. Cf. *Woods* v. *City Bank Co.*, 312 U. S. 262, 268. And this rule, for reasons which apply equally to the instant situation (*supra*, pp. 25–32), has been extended to members of protective committees.[29] *In re Republic Gas Corp.*, 35 F. Supp. 300 (S. D. N. Y.); *In re Paramount-Publix Corp.*, 12 F. Supp. 823 (S. D. N. Y.), affirmed 83 F. (2d) 1015 (C. C. A. 2). Under these de-

realistically with the job, as their controlling position obligated them to do, they shifted their position into securities which would survive the reorganization. While, therefore, the situation is not identical to that in the *Standard Gas* case, we submit that analogous equitable principles warrant attaching to the less serious breach of fiduciary obligations here involved the far less drastic consequences imposed by the Commission, namely, limitation of the management of Federal to cost plus 4 per cent.

[29] Comparable fiduciary obligations have been imposed by equity courts in analogous situations. Thus it has been held that corporate officers or directors may not buy up claims against a corporation in bankruptcy or undergoing reorganization and subsequently enforce them at their fair value. *In re Norcor Manufacturing Co.*, 109 F. (2d) 407 (C. C. A. 7); *In re McCrory Stores Corp.*, 12 F. Supp. 267 (S. D. N. Y.).

cisions members of protective committees who dealt in securities of the corporation pending reorganization have been precluded from receiving compensation for their services, because of their violation of fiduciary obligations. And the rule of these decisions has since expressly been adopted by Congress in Section 249 of the Bankruptcy Act (11 U. S. C., § 649),[20] while in Section 212 of that Act (11 U. S. C. § 612) Congress has authorized the courts to limit claims or stock purchased by a committee during the reorganization to the actual consideration paid—a principle which, it is to be noted, is more restrictive than that adopted by the Commission.

Similarly, under the requirement of Chapter IX (Section 83 (e) (1), 11 U. S. C., § 403 (e) (1)) of the Bankruptcy Act that compositions be "fair" and "equitable",[21] a standard analogous to that

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[20] See *Otis & Co.* v. *Insurance Bldg. Corp.*, 110 F. (2d) 353 (C. C. A. 1); *In re Mountain States Power Co.*, 118 F. (2d) 609 (C. C. A. 3).

[21] Section 83 (e) (1) provides that a plan may not be judicially confirmed unless it is "fair, equitable * * * and does not discriminate unfairly in favor of any creditor or class of creditors * * *." The words after "fair and equitable" are superfluous, for Congress has expressly recognized that, in any event, implicit in the clause "fair and equitable" is a "prohibition against any unfair discrimination in the plan in favor of any class of creditors or stockholders." Senate Judiciary Committee Report on the Revision of the National Bankruptcy Act, S. Rep. No. 1916, 75th Cong., 3rd Sess., pp. 35-36. Accordingly, Congress, when it enacted Chapter X (Section 221 (2), 11 U. S. C., § 621 (2)), did not repeat the latter expression which had appeared in Sections 77B (f) (1) and 83 (e) (1).

which the Commission was required to apply, this Court held that, to the extent that a fiduciary would profit in the plan by means of securities which he had acquired while performing his duties, "the plan would discriminate unfairly in [his] favor." *American Ins. Co.* v. *Avon Park*, 311 U. S. 138, 144.

Like the Commission's choice of remedy, its determination to apply the remedy irrespective of the absence of fraud or malfeasance in the particular case is also in accord with established principles. For as this Court has said in *Woods* v. *City Bank Co.*, 312 U. S. 262, 268, 269:

> • • • It is no answer to say that fraud or unfairness were not shown to have resulted. *Cf. Jackson* v. *Smith*, 254 U. S. 586, 589. The principle enunciated by Chief Justice Taft in a case involving a contract to split fees in violation of the bankruptcy rules, is apposite here: "What is struck at in the refusal to enforce contracts of this kind is not only actual evil results but their tendency to evil in other cases." *Weil* v. *Neary*, 278 U. S. 160, 173 • • •
>
> • • • A fiduciary who represents security holders in a reorganization may not perfect his claim to compensation by insisting that, although he had conflicting interests, he served his several masters equally well or that his primary loyalty was not weakened by the pull of his secondary one. Only strict adherence to these equitable principles can keep the standard of conduct

> for fiduciaries "at a level higher than that trodden by the crowd." See Mr. Justice Cardozo in *Meinhard* v. *Salmon*, 249 N. Y. 458, 464; * * *

Cf. *Pepper* v. *Litton*, 308 U. S. 295, 310-311."[32] The rule may in part be, as the court below observed, a "rule of convenience" (R. 148); but it is based upon well recognized factors. It is normally impossible to ascertain whether insiders have in fact taken advantage of the information specially available to them, and whether such information motivated or influenced their transactions. See the concurring opinion of Judge Learned Hand in *Morgan Stanley & Co.* v. *Secu-*

[32] It has been held in a variety of situations that absence of injury to corporations and good faith on the part of the fiduciary furnish no grounds for relieving fiduciaries of their legal duties. Thus, contracts between officers and their corporations are denied enforcement irrespective of damage to the corporation (*Wardell* v. *Railroad Co.*, 103 U. S. 651; *Lum* v. *McEwen*, 56 Minn. 278, 57 N. W. 662 (1894)); a trustee is forbidden to purchase the trust estate at a public sale, even if the trust estate is benefited by the purchase (*Magruder* v. *Drury*, 235 U. S. 106; *Ashman* v. *Miller*, 101 F. (2d) 85 (C. C. A. 6)); officers of a corporation in bankruptcy who purchase its claims at a discount and sell them at their face value must disgorge their profits, even if their activities were of service to the corporation and the corporation was itself unable to handle the claims (*In re Norcor Manufacturing Co.*, 109 F. (2d) 407 (C. C. A. 7); *In re McCrory Stores Corp.*, 12 F. Supp. 267 (S. D. N. Y.)); and officers of a corporation who seize a corporate opportunity for personal benefit may be called to account, even without a showing that the corporation was able to take the opportunity. *Irving Trust Co.* v. *Deutsch*, 73 F. (2d) 121 (C. C. A. 2), certiorari denied *sub nom. Bell* v. *Irving Trust Co.*, 294 U. S. 709.

rities and Exchange Commission, 126 F. (2d) 325, 332 (C. C. A. 2). And respondents' disclosure of their purchases was no safeguard against the abuse here involved; the possibility of advantages to management in its trading, by virtue of its power to time purchases, disclosures, and presentations of plans, is of such permeating importance that, if the investors are to be protected, the management in a situation such as this must be prohibited altogether from profiting from trading in the securities involved in the reorganization which the management formulates and controls.[33] See Note (1936) 46 Yale L. J. 143, 148.

We submit that the Commission's conclusion that the principles relating to the powers and duties of reorganization managers were applicable in the situation before it was peculiarly within the Commission's special administrative competence. The Commission has dealt extensively with corporate reorganizations, both under the Act, and under other statutes entrusted to it. It has, in addition, exhaustively studied protective and reorganization committees. See *Report on the Study and*

[33] There is no force in respondents' suggestion in their brief in opposition (p. 9) that the principle adopted by the Commission is inconsistent with the desirable end of management's holding of stock in corporations entrusted to it. The Commission's determination covers only management's personal acquisition of additional holdings during the pendency of reorganization. No cited principles or authorities *encourage* management to deal in their corporations' securities pending reorganization; and on the other hand nothing in the Commission's holding prevents respondents from purchasing the stock of the reorganized company *after* reorganization.

Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1936–1940). Particularly in these circumstances, the court below should not have rejected the Commission's application of reorganization principles.

The effect of Section 17 (b).—Nevertheless, the majority of the court below held (R. 144–145, 149–150) that whatever the desirability of the rule adopted by the Commission, the full measure of the Commission's power to restrict security transactions by directors and officers is marked by Section 17 (a) and (b) of the Act (Appendix, *infra*, pp. 53–54), which requires directors and officers to report their security holdings and which provides that profits realized by them from purchases and sales or sales and purchases of securities of the holding company within any period of less than six months shall inure to the benefit of the holding company. Accordingly, the court was of the view that the Commission was limited by the Act itself from imposing additional restrictions upon the common law right of directors and officers to purchase securities of the company.

We submit that Section 17 (b) does not mark the entire limits of fiduciary responsibility of officers and directors. Section 17 (b), which is the counterpart of Section 16 (b) of the Securities Exchange Act of 1934, deals primarily with transactions in normal situations; it was intended

simply to provide an "arbitrary rule of thumb" essentially designed to discourage short-term trading by insiders; the circumstances of the transaction are, with a single exception,[34] of no concern under the section. See Yourd, *Trading in Securities by Directors, Officers and Stockholders; Section 16 of the Securities Exchange Act* (1939), 38 Mich. L. Rev. 133, 148, 153. Here the Commission was dealing with a special situation, arising not from transactions in the ordinary course of corporate life, but from the dynamics of reorganization.[35] In times of reorganization, officers and directors assume additional functions which go beyond the day-to-day situation contemplated by Section 17 (b) and subject them to the broad standards of Sections 7 and 11.[36]

In *American Ins. Co.* v. *Avon Park*, 311 U. S. 138, 146, the Court stated that where investigation

[34] The restriction of Section 17 (b) does not apply where the "security was acquired in good faith in connection with a debt previously contracted * * *." Appendix, *infra*, p. 54.

[35] Thus it has been suggested that Section 16 (b), an extension of common law principles, could hardly have been intended by Congress to have limited the common law restriction upon fraudulent inside transactions, even beyond the six months' limitation. Yourd, *op. cit. supra*, pp. 147–148.

[36] In a similar situation, this Court applied the general principle forbidding fiduciaries to represent conflicting interests, although other equitable principles applicable to fiduciaries were codified in Sections 249 and 212, and in former Section 77B (h). *Woods* v. *City Bank Co.*, 312 U. S. 262. These codified principles, thus, were not treated as excluding uncodified principles.

shows a "breach of fiduciary obligations, profiting from a trust, special benefits for the reorganizers, or the need for protection of investors against an inside few," a bankruptcy court had ample power to adjust the remedy to meet the need. It may, this Court said, limit the vote to the amount paid for the securities; it may separately classify claimants; it may completely subordinate some of the claims. The power

> is ample for the exigencies of the varying situations. It is not dependent on express statutory provisions. It inheres in the jurisdiction of a court of bankruptcy. The necessity for its exercise * * * is based on the responsibility of the court before entering an order of confirmation to be satisfied that the plan in its practical incidence embodies a fair and equitable bargain openly arrived at and devoid of overreaching, however subtle. * * *

Nothing either in the terms or the legislative history of the Act indicates that the standards of fairness and equity embodied in the Act were intended to have narrower meaning than they have in bankruptcy proceedings in the courts, or that the Commission has less power in applying these standards than that which "inheres in the jurisdiction of a court of bankrputcy" and which is "not dependent on express statutory provisions." On the contrary, the very breadth of the terms of Sections 7 and 11, as well as their history, estab-

lishes that the Commission was intended to be vested with authority to deal as it did here with situations like the present. Thus, Congress stated (S. Rep. 621, 74th Cong., 1st sess. (1935) p. 28) that the provisions of Section 7—

> are designed to give to the Commission continuous supervision over the revamping of holding-company systems to meet the requirements of title I looking toward the establishment of financially sound and economically integrated units and the avoidance of injury to investors * * * *

and that the terms and conditions which the Commission is authorized to impose under Section (f)—

> are designed to give adequate protection to investors and consumers * * * and are in accord with the underlying purpose of the legislation to give to investors and consumers full protection against the deleterious practices which have characterized certain holding-company finance in the past. * * *

So too, it is plain that Congress intended to permit the broadest scope to the Commission in applying the standards embodied in Section 11 in order to effectuate the purpose of the Act in the very situation comparable to that involved here; it was stated (S. Rep. 621, 74th Cong., 1st sess. (1935), p. 33):

> Under these subsections [11 (d), (e), and (f)] Commission approval of reorganiza-

> tion plans and supervision of the conditions under which such plans are prepared will make it impossible for a group of favored insiders to continue their domination over inarticulate and helpless minorities, or even as is often the case, majorities.[37] * * *

Thus, plainly, Congress broadly committed to the Commission the determination whether changes in the rights of security holders such as those proposed by the respondents would be detrimental to the interests of investors, and whether respondents' proposal to redistribute voting power in such a manner as to treat their newly acquired securities on a parity with others would be fair and equitable. The legislative history of Sections 7 and 11 wholly negates any thought that the Congress by Section 17 intended to limit the Commission's power, in proceedings under Sections 7 and 11, to apply appropriate equitable sanctions to the abuse of fiduciary duties, or that it was intended to vest the

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[37] Compare the even more explicit statement embodied in the Report of the National Power Policy Committee, which was annexed to the Senate Committee report (S. Rep. 621, 74th Cong., 1st Sess.). In discussing a provision comparable to the present Section 11 (e), and after referring to the complexities of reorganization involved in the dismantling of vast holding company systems, the report stated (p. 58):

> In destroying the abuses of the holding companies, the Government must not leave great groups of helpless investors to the certain abuses of extensive hurried corporate reorganizations. The dominant groups who have ruthlessly plucked the investor in promoting some of these huge holding companies must not be allowed to pluck him again as reorganization managers.

Commission with less discretion over reorganizations within its jurisdiction than that which inheres in bankruptcy courts in respect of reorganizations within their jurisdiction." See Note (1942) 56 Harv. L. Rev. 126, 128.

CONCLUSION

For the foregoing reasons, the judgment of the court below should be reversed.

Respectfully submitted.

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NOVEMBER 1942.

[35] The court below, however, in (R. 149) support of its view that Section 17 (b) was intended to regulate the entire field, referred to the Report of the Securities and Exchange Commission on proposals for amendment to the Securities Act of 1933 and the Securities Exchange Act of 1934, 77th Cong., 1st Sess., House Committee Print (1941),

p. 36 (where it was emphasized that an insider is required to disgorge profits only when the profits are made within six months), and to the testimony of Chairman Purcell (Hearings before Committee on Interstate and Foreign Commerce on H. R. 4344, H. R. 5065, and H. R. 5832, 77th Cong., 1st Sess. (1942), p. 1255), that Congress prohibited only "the most prevalent form of the abuse of inside information—trading designed to take quick profits from short-term market fluctuations." But these statements are irrelevant here; they were directed toward proposals drastically to amend or repeal Section 16 of the Securities Exchange Act of 1934 and were on behalf of retention of that section.

APPENDIX

The pertinent provisions of the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 803 (15 U. S. C., §§ 79, *et seq.*), are as follows:

SECTION 1. (a) Public-utility holding companies and their subsidiary companies are affected with a national public interest in that, among other things, (1) their securities are widely marketed and distributed by means of the mails and instrumentalities of interstate commerce and are sold to a large number of investors in different States; * * *

(b) Upon the basis of facts disclosed by the reports of the Federal Trade Commission * * * it is hereby declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected—

(1) when such investors cannot obtain the information necessary to appraise the financial position or earning power of the issuers, because of the absence of uniform standard accounts; when such securities are issued without the approval or consent of the States having jurisdiction over subsidiary public-utility companies; when such securities are issued upon the basis of fictitious or unsound asset values hav-

ing no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies; when such securities are issued by a subsidiary public-utility company under circumstances which subject such company to the burden of supporting an overcapitalized structure and tend to prevent voluntary rate reductions;

* * * * * *

(5) when in any other respect there is * * * lack of effective public regulation * * *.

(c) When abuses of the character above enumerated become persistent and widespread the holding company becomes an agency which, unless regulated, is injurious to investors, consumers, and the general public; and it is hereby declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the evils as enumerated in this section, connected with public-utility holding companies which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems, and to provide as soon as practicable for the elimination of public-utility holding companies except as otherwise expressly provided in this title.

* * * * * *

Section 6 (a):

SEC. 6. (a) Except in accordance with a declaration effective under section 7 and with the order under such section permitting such declaration to become effective, it shall be unlawful for any registered holding company or subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly (1) to issue or sell any security of such company; or (2) to exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of such company.

* * * * *

Section 7:

SEC. 7. (a) A registered holding company or subsidiary company thereof may file a declaration with the Commission, regarding any of the acts enumerated in subsection (a) of section 6, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. * * *

* * * * *

(b) A declaration filed under this section shall become effective within such reasonable period of time after the filing thereof as the Commission shall fix by rules and regulations or order, unless the Commission prior to the expiration of such period shall have issued an order to the declarant to show cause why such declaration should become effective. Within a reasonable time after an opportunity for hearing upon an order to show cause under this subsection, unless the declarant shall withdraw its declara-

tion, the Commission shall enter an order either permitting such declaration to become effective as filed or amended, or refusing to permit such declaration to become effective. Amendments to a declaration may be made upon such terms and conditions as the Commission may prescribe.

(c) The Commission shall not permit a declaration regarding the issue or sale of a security to become effective unless it finds that—

* * * * *

(d) If the requirements of subsections (c) and (g) are satisfied, the Commission shall permit a declaration regarding the issue or sale of a security to become effective unless the Commission finds that—

* * * * *

(6) the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers.

(e) If the requirements of subsection (g) are satisfied, the Commission shall permit a declaration to become effective regarding the exercise of a privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security unless the Commission finds that such exercise of such privilege or right will result in an unfair or inequitable distribution of voting power among holders of the securities of the declarant or is otherwise detrimental to the public interest or the interest of investors or consumers.

(f) Any order permitting a declaration to become effective may contain such terms and conditions as the Commission finds nec-

essary to assure compliance with the conditions specified in this section.

* * * * *

Section 11 (b) (2):

(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

* * * * *

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company,

or of any company whose principal business is that of a public-utility company.

* * * * * *

Section 11 (e):

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take

exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

* * * * * *

Section 17 (a) and (b):

SEC. 17. (a) Every person who is an officer or director of a registered holding company shall file with the Commission in such form as the Commission shall prescribe (1) at the time of the registration of such holding company, or within ten days after such person becomes an officer or director, a statement of the securities of such registered holding company or any subsidiary company thereof of which he is, directly or indirectly, the beneficial owner, and (2) within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, a statement of such ownership as of the close of such calendar month and of the changes in such ownership that have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company or any subsidiary company thereof, any profit realized by any such officer or director from any purchase and sale, or any sale and purchase, of any security of such registered holding com-

pany or any subsidiary company thereof within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the holding company or subsidiary company in respect of the security of which such profit was realized, irrespective of any intention on the part of such officer or director in entering into such transaction to hold the security purchased or not to repurchase the security sold for a period of more than six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the company entitled thereto or by the owner of any security of such company in the name and in the behalf of such company if such company shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not cover any transaction where such person was not an officer or director at the times of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may, as necessary or appropriate in the public interest or for the protection of investors or consumers, exempt as not comprehended within the purpose of this subsection. Nothing in this subsection shall be construed to give a remedy in the case of any transaction in respect of which a remedy is given under subsection (b) of section 16 of the Securities Exchange Act of 1934.

* * * * *

Section 24 (a):

SEC. 24. (a) Any person or party aggrieved by an order issued by the Commission under this title may obtain a review of such order in the circuit court of appeals of the United States within any circuit wherein such person resides or has his principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the entry of such order, a written petition praying that the order of the Commission be modified or set aside in whole or in part. * * * The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. * * * The judgment and decree of the court affirming, modifying, or setting aside, in whole or in part, any such order of the Commission shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in sections 239 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 346 and 347).

U. S. GOVERNMENT PRINTING OFFICE: 1943

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IN THE

Supreme Court of the United States

October Term, 1942.

No. 254.

SECURITIES AND EXCHANGE COMMISSION, *Petitioner*,

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., *Respondents*.

BRIEF OF CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., IN OPPOSITION TO PETITION FOR CERTIORARI.

SPENCER GORDON,
Attorney for Respondents.

COVINGTON, BURLING, RUBLEE, ACHESON & SHORB,
Of Counsel.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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BRIEF OF CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., IN OPPOSITION TO PETITION FOR CERTIORARI.

Opinions Below and Jurisdiction.

The citation of the opinions below and the statement of the jurisdiction are correctly given in the petition.

Statement.

The respondents on behalf of whom this brief is filed are seventeen individuals and one corporation who purchased preferred stock in Federal Water Service Corporation

(hereinafter called "Federal") during the period when a plan of reorganization of that company, which was later changed to a plan of merger with Utility Operators Company and Federal Water and Gas Corporation, was under consideration by the Securities and Exchange Commission. The respondents other than Chenery Corporation were officers or directors of Federal or of Utility Operators. Chenery Corporation is a family holding company which had nine stockholders, of whom two, who owned approximately 47 per cent of the stock of Chenery Corporation, were officers or directors of Federal or Utility Operators. All of the purchases were currently reported to the Commission by the purchasers as required by Section 17 of the Public Utility Holding Company Act of 1935. (R. 13, 56, 61).

The Commission refused to permit the preferred stock so purchased by the respondents to participate equally with preferred stock of the same class, and approved the reorganization only on condition that the respondents should surrender their stock to the resulting corporation at cost plus 4 per cent. Upon appeal by the respondents this order was reversed by the United States Court of Appeals for the District of Columbia. (R. 63, 97, 111, 139).

The purchases in question involved approximately 12,000 shares out of a total issue of approximately 160,000 preferred. During the same period more than 130,000 shares of the preferred stock were transferred to other parties. (R. 56-61, 65). The conditions under which the stock was purchased and the issue raised thereby were thus succinctly stated by the Court of Appeals:

> "When the plan was first proposed, members of the Commission's staff objected to the retention of voting power in Federal by its Class B common stock, substantially all of which belonged to Utility Operators Company, which in turn was controlled by officers and directors of Federal. This opposition held in suspense for two and a half years the proposed plan and vari-

ous subsequently suggested amendments.* Notice of the Commission's position in this regard was made public both by the Commission and Federal, and it is agreed was known and understood by stockholders or investors. Realizing that if the Commission persisted in this stand the officers and employees of Federal who had invested in this class of stock would find themselves without either a stake or influence in the company they had helped to create and by which they were employed, Chenery, president of Federal, suggested to many of them that they use what money they could spare to buy preferred stock, stating that he would follow the same course. This resulted in purchases over a period of two and a half to three years on the part of various officers and directors of the corporation. The average purchase of each of the 16 officers and directors, other than Chenery and one Vandenberg was around 130 shares. Chenery, for the account of a family corporation controlled by him, purchased approximately 8,000 shares, of which a lot of 2,700 shares was not a purchase but an exchange for $100,000 of Federal's prior debenture gold bonds, and as to which the other party to the transaction testified that he preferred to have the bonds to the stock 'and today I am very much delighted we made the trade'. The remaining director, Vandenberg, who at the time of the merger—we gather from the record—had ceased to be an officer and director of the corporation, purchased in the open market approximately 1,700 shares.

"The Commission's brief and argument in this court explicitly declare that the conclusion to outlaw this stock is not 'predicated on any finding that petitioners† defrauded or failed to make the fullest disclosure to the stockholders from whom they purchased the shares in question.' On the contrary, the Commission, very properly, admits that the transactions complained of were consummated without 'any ulterior purpose' and equally without any intention to profit personally 'in the consummation of the plan through having traded

* The plan was also delayed by difficulties created by the law of Delaware, which were finally resolved by the decision on January 16, 1940, in *Havender* v. *Federal United Corporation*, 11 A. (2d) 331 (Del. Sup. Ct. 1940). (R. 67).

† Respondents in this Court.

while the proceedings were pending'. We have, therefore, a case in which the facts are agreed, the good faith of petitioners* admitted, and the decision based squarely on the assumption that the purchase of securities of a corporation by its officers or directors for their own account, pending action on an application for approval of a merger, is 'detrimental to the public interest' as that phrase is used in Section 7(d)(6) of the Act." (R. 142).

The Court said further in regard to the purchases:

"* * * it is admitted that there was a full and free disclosure before any purchases were made, the exercise of the utmost good faith throughout, * * *" (R. 146).

"And yet the Commission proposes to annul, not transactions growing out of an abuse of inside information, but transactions as to which both buyer and seller were equally informed of the facts,—not trading designed to take quick profits from short term market fluctuations, but trading for investment by one whose income depended at least in part upon the success of the corporation of which he was an officer." (R. 149).

The Court of Appeals held that no statute, regulation, or rule of common law or equity proscribed this purchase of stock (R. 143), that the statutory phrase "detrimental to the public interest" was never intended to proscribe an investment made under these circumstances (R. 149), and that the action of the Commission constituted retrospective legislation. (R. 150). The order of the Commission was therefore reversed. (R. 150).

* Respondents in this Court.

Argument.

The Question is Not One of Public Importance.

The Commission, as petitioner, has failed to sustain the burden of showing that the question is one of such public importance as would warrant review by certiorari. This burden has been described as follows:

> "The density of litigation dependent upon the ruling in a particular case and its repercussion upon affairs, governmental or economic, are the chief determinants of importance. And these will vary according to time and circumstance." Frankfurter and Fisher, *The Business of the Supreme Court at the October Terms, 1935 and 1936*, 51 Harv. L. Rev. 577, at 597-598 (1938).

Here there is no density of litigation dependent upon the ruling. The Commission says (Petition p. 11):

> "In several cases now pending before it, the Commission is faced with substantially the same issue as was before it in the instant case."

A supporting footnote states that in *Derby Gas and Elec. Corp.*, Holding Company Act Release No. 2875 (July 12, 1941), the Commission made findings similar to those herein, that in *The Middle West Corporation*, Holding Company Act Release No. 3580 (June 5, 1942), the Commission withheld decision because of the decision of the Court of Appeals in the instant case, and that the pendency of at least six other cases involving the issue decided herein has been ascertained from the Commission's files. Whether any of these eight cases involve substantially the same issue as in the instant case is certainly debatable. In one of the cases cited the subsidiary's shares were purchased by its parent corporation and in the other by the predecessor in title of the parent corporation. Neither case involved purchases by officers or directors of either the parent or subsidiary corporations. As the names of the six other cases have not been given we have no means of knowing whether or not

they bear any greater similarity to the pending case than the two cases cited.

Even if the eight cases cited or referred to by the Commission should prove to be in some respect dependent upon the instant case, the number of such cases appears to be relatively small in view of the fact that the Public Utility Holding Company Act has been in operation for approximately seven years. It is also significant that no cases involving the present question have been found in the field of corporate reorganization prior to the entry therein of the Securities and Exchange Commission.

The Commission cannot sustain its allegation of public importance by a mere showing that its decision has been reversed by the Court of Appeals. All cases involving Federal agencies presumably involve the administration and interpretation of Federal statutes, but they are not all so important that they should be reviewed by this Court on certiorari. The mere fact that a court has disagreed with a ruling or interpretation of a Federal agency does not make the case an important one. To illustrate, in each of the following cases in the last two terms of the Supreme Court, a Federal authority petitioned for a writ of certiorari alleging the existence of a question of public importance, but in each case the petition was denied:

OCTOBER TERM, 1941.

No. 987 *Federal Power Commission* v. *Safe Harbor Water Power Corp.*, April 6, 1942, CCA 3rd, jurisdiction of the Federal Power Commission to regulate interstate wholesale rates of a licensed hydroelectric project under Section 20 of Part I of the Federal Power Act. 314 U. S. ——.

No. 1049 *Federal Deposit Insurance Corporation, Receiver*, v. *White et al.*, April 27, 1942, CCA 4th, application of state statute of limitations to a cause of action created by Federal law, and the power of the Comptroller of the Currency and the Federal Deposit Insurance Corporation to take action against directors of an insured national bank who are converting its assets. 315 U. S. ——.

No. 1161 *Helvering, Commissioner of Internal Revenue*, v. *Maytag, Alternate Executor*, and No. 1162 *Helvering, Commissioner of Internal Revenue*, v. *Maytag et al., Executors*, May 25, 1942, CCA 8th, application of the "blockage" theory in the valuation for estate and gift tax purposes of large blocks of stock regularly traded in upon the New York Stock Exchange. 315 U. S. ——.

OCTOBER TERM, 1940.

No. 184 *Helvering, Commissioner of Internal Revenue*, v. *Horseshoe Lease Syndicate*, October 14, 1940, CCA 5th, whether respondent was an "association" within the meaning of Section 1111 (a)(2) of the Revenue Act of 1932 and hence subject to income tax as a corporation. 311 U. S. 666.

No. 249 *Helvering, Commissioner of Internal Revenue*, v. *Rector & Davidson*, October 14, 1940, CCA 5th, on same point as that presented by No. 184, *supra*. 311 U. S. 672.

No. 231 *Helvering, Commissioner of Internal Revenue*, v. *Jennings et al.*, November 18, 1940, CCA 5th, whether under Section 23(g) of the Revenue Act of 1936 taxpayers could offset personal losses from gambling operations against their distributive shares of partnership gains from similar operations. 311 U. S. 704.

No. 764 *Helvering, Commissioner of Internal Revenue*, v. *Cleveland Trust Company, Trustee*, March 17, 1941, CCA 6th, whether respondent was an "association" taxable as a corporation under Section 801 of the Revenue Act of 1934 or was taxable merely as a pure trust under Section 161. 312 U. S. 704.

No. 894 *National Labor Relations Board* v. *E. I. Du Pont De Nemours & Co.*, and No. 895 *National Labor Relations Board* v. *Association of Chemical Employees at Belle Works of E. I. Du Pont De Nemours & Co.*, May 5, 1941, CCA 4th, whether the Board could validly find that Du Pont & Co. violated Section 8 (1) and (2) of the National Labor Relations Act; whether the Board could properly issue a cease-and-desist and disestablishment orders despite the fact that the illegal employee representation schemes had disappeared by

the time of hearing; and whether certain activities of supervisory employees justified the issuance of a cease-and-desist order against the employer. 313 U. S. 571.

The Decision of the Court Below is Clearly Correct.

An officer or director may freely purchase stock of the corporation from its stockholders, provided only that he is not guilty of fraud or misrepresentation. Such is the law of Delaware, where the three corporations involved in this case were organized, *Cahall* v. *Lofland*, 12 Del. Ch. 229, 114 Atl. 224 (1921), aff'd 13 Del. Ch. 384, 118 Atl. 1 (1922); *Dupont* v. *Dupont*, 242 Fed. 98, 256 Fed. 129, cert. denied, 250 U. S. 642, and elsewhere.

> "Indeed, as far as we are able to find, no case has gone to the length of holding a director accountable to a stockholder in the purchase and sale of shares of stock except where fraud or some form of overreaching is shown as the inducing cause of the transaction". (R. 144).

No statute prohibited purchases such as those involved in this case. No regulation of the Commission prohibited such purchases.

If Congress had intended to bring about the result desired by the Commission, a section would have been included in the Public Utility Holding Company Act of 1935, 49 Stat. 803, to provide that officers and directors who purchase stock while a plan of reorganization is under consideration by the Commission shall be required to surrender such stock at cost as a prerequisite to the approval of such a plan. But Congress did not so provide. The Public Utility Holding Company Act of 1935, which is the only statute involved in this proceeding, did deal with purchases of stock by officers and directors, but contained a totally different provision.

After extended hearings on the subject of stock transactions by officers and directors, Congress settled the prob-

lem in Section 17 of the Act. Every officer or director of a registered holding company was required in Section 17(a) to report the securities owned by him in the company or in any subsidiary thereof, and to make monthly reports showing all further purchases and sales. This was obviously for purposes of publicity. Congress further enacted in Section 17(b) that any profit derived from purchases or sales within a holding period of less than six months should inure to the corporation. Section 17(b) states that this was—

> "For the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company or any subsidiary thereof * * *"

Senator Fletcher, in reporting the Securities Exchange Act of 1934, from which Section 17 of the Public Utility Holding Company Act of 1935 was bodily taken, said of that section:

> "Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others." Senate Report No. 792, 73rd Congress, page 9.

Since the problem of purchases of securities by management was expressly covered by Section 17, no further prohibition or limitation is to be read into the statute through the general language of other sections. Congress clearly did not intend that profits from purchases by management should inure to the corporation, *except* in those specified instances where the profit was realized *within six months* of the date of purchase. The present contention of the Commission that officers and directors should give up stock acquired over a period of two and a half years and held for

investment ignores all tenets of statutory construction. On this point the Court of Appeals said:

> "Clearly, the enactment of Section 17 was intended to restrict a recognized existing right and place a definite and certain limitation on its exercise. But subject to its provisions, officers and directors of a corporation are permitted to deal in its securities. Of this, and of the exercise of the right, day after day, without question, there can be no manner of doubt. And this is just a recognition by Congress of the rule that, while officers and directors are trustees for stockholders as a body with respect to the business and property of the corporation and in the managment of its affairs, they are not trustees—in the sense we are concerned with here—to the individual stockholder, since they have no control over his shares." (R. 145).

The decisions cited by the Commission in support of its contention involve the purchase of trust property by a trustee, fraud or other inequitable conduct, or express provisions of the bankruptcy laws or other statutes. These cases were carefully reviewed and distinguished by the Court of Appeals. (R. 146, 147, 148).

There is no basis in principle or authority for the attempted distinction, as concerns the right of directors to purchase stock, between a corporation which is in the process of reorganization and a corporation for which no plan of reorganization is contemplated. Officers and directors will always know more about the affairs of a corporation than will mere stockholders. This will be so from the organization of the corporation to its final dissolution. It will be so whether the corporation is prosperous or is in failing circumstances, whether it is being reorganized or whether it is not being reorganized.

Until the Commission's action in this case purchase of stock by officers and directors has never been discouraged. On the contrary, a number of states require that directors be stockholders. A criticism often heard in regard to modern corporate practice is that management often does not own enough stock in the enterprises entrusted to it.

The fact that a registered public utility holding company is required to submit a plan to the Commission before the rights of its stockholders can be modified, creates even less basis for the assertion of a duty upon the part of the officers and directors to refrain from purchasing or selling the corporation's stock than would be the case in an ordinary corporate reorganization. The officers and directors of a public utility holding company can only propose a plan for the consideration of the Commission. They cannot even solicit proxies without first obtaining a report upon the plan from the Commission. (Secs. 11(g), 12(e)). The approval of the plan must be by the Commission, and its confirmation must be by the stockholders in accordance with state law, in this case by two-thirds of the stockholders with the right on the part of a dissenting stockholder to have an appraisal and the value of his stock in cash. Delaware Corporation Law, Secs. 59, 61. There is no occasion for the invention of a new principle of corporate law in order to protect these stockholders.

If there is to be any extension of the liability of directors in such situations it should be done by Congress and not by the Commission. Thus the Court of Appeals stated:

> "But, if the Commission's objective is to be attained, it should be only after the *pros* and *cons* have been carefully weighed in their relation, respectively, to the dangers and benefits, and the scales should be controlled by Congress and not by the Commission. In short, all that we hold is that this vital question of policy is one for the Congress and not for the Commission. Until Congress acts to change the standard it has expressly set up in the Act, action by the Commission to expand or enlarge its terms, and to make such expansion or enlargement apply to transactions three years old, is we think, with great deference to the Commission, neither more nor less than retrospective legislation." (R. 149).

Conclusion.

Because the case is not one of public importance and because the decision below is clearly correct, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., *Respondents*.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia.

BRIEF FOR THE RESPONDENTS CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.

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Supreme Court of the United States

OCTOBER TERM, 1942.

No. 254.

SECURITIES AND EXCHANGE COMMISSION, *Petitioner*,

v.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL., *Respondents.*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia.

BRIEF FOR THE RESPONDENTS CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, ET AL.

OPINION BELOW.

The opinion of the Court of Appeals (R. 139-155) is reported in 128 F. (2d) 303. The findings and opinion of the Commission (R. 63-79, 115-132) are reported in 8 S. E. C. 893. The supplemental findings and opinion of the Commission (R. 104-113) and the report of the Commission on a plan of reorganization (R. 97-104) are reported in S. E. C. Holding Company Act Release No. 3023.

JURISDICTION.

The judgment of the Court of Appeals was entered April 27, 1942 (R. 155). The petition for a writ of certiorari was filed July 25, 1942, and was granted October 13, 1942 (R. 159). This Court appears to have jurisdiction under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, made applicable by Section 24 (a) of the Public Utility Holding Company Act of 1935.

STATEMENT OF CASE.

Federal Water Service Corporation (hereinafter called Federal), a Delaware corporation, was a holding company owning securities of subsidiaries which operated water, gas, electric and other properties. November 8, 1937, Federal registered with the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935, and filed with the Commission, under Section 7 of said act and the rules of the Commission, an application for a report on a plan of reorganization, and declarations regarding the alteration of rights of holders of outstanding securities and the solicitation of consents. The application and declarations set forth a plan for the voluntary reorganization of Federal, to be accomplished by amendment to its certificate of incorporation pursuant to Section 26 of the Delaware Corporation Law, and by a reduction in its capital pursuant to Section 28 of the Delaware Corporation Law. At the time of the filing of the application and declarations, Federal had outstanding six classes or series of stock: $7, $6.50, $6, $4 series preferred stock, Class A stock and Class B stock. Dividends in arrears had accumulated on all series of preferred stock and upon the Class A stock. Federal had valuable assets and had substantial annual net income, but, by reason of earlier losses and depreciation in the value of investments, the corporation had a capital deficit which

under Delaware law prevented the payment of dividends. The plan contemplated the simplification of the corporate structure and the elimination of the capital deficit by a reduction of capital, so that the corporation might resume the payment of dividends. (R. 18, 19, 63-67.)

The Commission objected to the plan first proposed, new plans were filed, and continued discussions were had with representatives of the Commission toward the development of a plan which the Commission would permit to become effective under the Public Utility Holding Company Act of 1935, which would comply with the law of Delaware as to the rights of holders of preferred stock to arrears of dividends, and which would also command the necessary consent of the stockholders of Federal as required by Delaware law. After the decision on January 16, 1940, in *Havender v. Federal United Corporation*, 11 A. (2d) 331, which established that under Delaware law preferred stock together with dividends in arrears thereon might be converted into new securities through a merger, Federal filed with the Commission on March 30, 1940, amendments to its application and declarations, setting forth a new plan of reorganization by way of merger. The amendments proposed the merger into Federal of two other Delaware corporations, Utility Operators Company and Federal Water and Gas Corporation. Utility Operators Company, the stock of which was largely owned by officers and employees of Federal and its subsidiary companies, owned all of the Class B stock of Federal. Federal owned all of the stock of Federal Water and Gas Corporation. Utility Operators Company and Federal Water and Gas Corporation also filed with the Commission declarations regarding the alteration of the rights of the holders of their securities in accordance with the proposed merger agreement. (R. 63, 64, 67)

During the period from November 8, 1937, to June 30, 1940, the respondents purchased preferred stock in Federal in amounts as follows:

Name	Shares $6.00 Preferred	$6.50 Preferred	$7.00 Preferred
Chenery Corporation	3860	3547	1211
H. M. Erskine	25	50	——
R. H. Neilson	10	——	——
W. A. Culin	50	110	——
F. T. Tansill	——	65	——
H. D. McHenry	——	75	15
T. H. Wiggin	50	30	——
C. M. Chenery	150	170	——
J. N. Greene	45	——	——
H. G. Calder	——	40	——
C. P. Rather	110	310	——
Wm. E. Matthews, III	——	65	——
C. van den Berg, Jr.	25	1535	140
W. R. Edwards	100	——	——
Watson Dark	5	160	60
E. C. Deal	85	——	——
F. R. Harris	130	173	40
E. C. Elliott	27	——	——
Total purchased by respondents	4672	6330	1466

A comparison of these purchases with the total stock transferred during the period and the total stock outstanding in each class is:

	$6.00 Preferred	$6.50 Preferred	$7.00 Preferred
Total outstanding	71,706	69,888	15,296
Transfers during period from January 1, 1938, to June 30, 1940*	69,578	61,595	12,919
Purchased by respondents during period from November 8, 1937, to June 30, 1940	4,672	6,633	1,466

* This does not include transfers from November 8, 1937, to December 31, 1937, inclusive, since the evidence only gave that year as a whole. It is an interesting coincidence that during the period in question an amount of stock changed hands which was approximately equal to the total amount outstanding. Petitioners purchased something less than 9 per cent of the stock sold.

The only sales of this stock by respondents during the period were: C. M. Chenery sold 125 shares of the $6.00 preferred stock and 20 shares of the $6.50 preferred stock, and C. van den Berg, Jr., sold 25 shares of the $6.00 preferred stock and 700 shares of the $6.50 preferred stock. (R. 56-61, 65)*

When these purchases were made the respondents other than Chenery Corporation were officers or directors of Federal or of Utility Operators Company. Chenery Corporation was a family holding company which had nine stockholders, of whom two, who owned approximately 47 per cent of the stock of Chenery Corporation, were officers or directors of Federal or Utility Operators Company. All of these purchases and sales of stock in Federal were currently reported to the Commission by the purchasers as required by Section 17 of the Public Utility Holding Company Act of 1935. (R. 13, 56-61)

June 29, 1940, the Commission issued tentative findings in which the question was raised for the first time whether the preferred stock which had been purchased by officers and directors of Federal and Utility Operators Company and by Chenery Corporation while plans of reorganization were pending before the Commission should be treated on any different basis than other preferred stock. (R. 10, 23.) Hearings were had on this question, and C. T. Chenery, the President of Federal, testified that he had advised the purchases of preferred stock of Federal by the Chenery Corporation and by the individual officers and directors, because he believed that the preferred stock was a very good investment, and because by its purchase the management could maintain a voting interest if the B stock should be eliminated. The testimony also showed that full information in regard to the corporation had always been given to the stockholders and to the public. (R. 24, 27, 28)

* In the brief for the Commission counsel repeatedly state that respondents were "trading" in Federal stock. This is hardly accurate. Respondents were purchasing for investment. Their sales were negligible.

The successive plans for reorganization as filed from time to time with the Commission were available to the public, including all stockholders, as were all financial reports filed with the Commission. (R. 17, 22) Mr. Culin, the treasurer of Federal, testified that the management had always been very free in giving information to everyone who asked for it. (R. 27) Annual reports of the company gave full information, quarterly earning statements were published in the financial pages of the newspapers, the newspapers carried reports of the plans before the Commission from time to time, and various investment houses also gave information and advice with respect to the stock. (R. 28)

Mr. Chenery testified:

> "* * * my feeling has been that if there is one corporation that has ever operated in the full blare of publicity, that this one is it. It was one of the first corporations to start and give full and complete details of every transaction. Standard Statistics has given reports at three-month intervals. There have been a dozen brokerage houses which have circularized preferred stockholders consistently, telling them of every development and plan and advising them what to do. Our own policy has been not to refuse any stockholder any information at any time. There is no record since we have been in control of the company since March 14, 1932, of our having refused any stockholder any information on any subject." (R. 32)

Stock of Federal was sold in the over-the-counter market, and its quotations appeared daily in New York newspapers. All of the purchases in questions were made in the open market, except in one instance when Chenery Corporation acquired 2700 shares of 6½ per cent preferred from the investment house of Ingalls & Snyder in exchange for $100,000 principal amount of Federal debentures. (R. 15) Mr. Ingalls testified that his firm had full knowledge of the facts relating to Federal, and that

> "* * * today I am very much delighted we made the trade. * * * it's been a most satisfactory trade." (R. 36)

Mr. Ingalls also testified that he knew that officers and directors of Federal had been purchasing the preferred stock during the three or four years before he sold his stock. (R. 37)

March 24, 1941, the Commission filed formal findings and an opinion in the proceeding. The plan then under consideration had contemplated the conversion of the four classes of preferred into new common stock. The Commission stated that the plan could not be approved in so far as it provided for participation of the preferred shares purchased by officers or directors of Federal or Utility Operators Company, or by the Chenery Corporation, after November 8, 1937, on a parity with other shares of preferred stock of the same class. (R. 71-79) The Commission held that the officers and directors were "trustees" who had purchased trust property, that they must account for any profit on such purchases and that

> "... honesty, full disclosure and purchase at a fair price do not take the case out of the rule." (R. 73)

Entry of an order was deferred, and it was stated that further consideration would be given to the matter if Federal filed amendments to its proposed plan designed to cure this and other alleged defects therein. (R. 79)

Thereafter amendments to the declarations and applications were filed by the corporations, in order to present a plan which complied with the findings and opinion of the Commission. The proposed merger agreement was amended to provide among other things that no shares of common stock of the surviving corporation should be issued for the shares of preferred stock of Federal purchased since November 8, 1937, by Chenery Corporation or by the individual petitioners when they were officers or directors of Federal or of Utility Operators Company, but that each such purchaser should receive upon surrender of such stock to the surviving corporation the cost of such stock with interest at 4 per cent per annum from the dates of its

purchase to the effective date of the merger agreement. It was further provided in effect that the respondents should account to the surviving corporation for any profit realized on any such stock as had been sold by them. (R. 79-85)

August 15, 1941, the respondents filed an application for leave to intervene in the proceedings before the Commission, and objected to the approval of any plan of reorganization containing a provision to the effect that the preferred stock purchased by the respondents should be treated on a less favorable basis than other preferred stock of the same class. (R. 85) August 18, 1941, the respondents were given permission to intervene and were made parties to the proceeding with leave to file a brief. (R. 96)

September 24, 1941, the Commission made a report on the amended plan of reorganization, entered supplemental findings and opinion, and issued an order permitting the declarations, as amended in conformity with the Commission's opinion of March 24, 1941, to become effective, and granting the applications as amended. The effect of this order was to deny the prayers contained in the intervening petition and brief of the respondents. (R. 105, 108)*

Upon appeal by the respondents, this order was reversed by the United States Court of Appeals for the District of Columbia. (R. 139) The Court stated in regard to the purchases,

> "The Commission's brief and argument in this court explicitly declare that the conclusion to outlaw this stock is not 'predicated on any finding that petitioners** defrauded or failed to make the fullest disclosure to the stockholders from whom they purchased the shares in question.' On the contrary, the Commission, very properly, admits that the transactions complained of were consummated without 'any ulterior purpose' and

* As stated by the Court of Appeals (R. 143), this order was entered under Section 7. This is clear from the terms of the order. (R. 108)

** Respondents in this Court.

equally without any intention to profit personally 'in the consummation of the plan through having traded while the proceeedings were pending'. We have, therefore, a case in which the facts are agreed, the good faith of petitioners admitted,* and the decision based squarely on the assumption that the purchase of securities of a corporation by its officers or directors for their own account, pending action on an application for approval of a merger, is 'detrimental to the public interest' as that phrase is used in Section 7(d)(6) of the Act." (R. 142)

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* Counsel for the Commission apparently take a different attitude in this Court. For the first time, by the use of such expressions as "self-imposed limitations" and "the prejudice to security holders if antagonistic trading interests of the management should lead it to delay the presentation of an adequate plan" (Brief pp. 8 and 33), they now apparently seek to give the impression that respondents purposely delayed the submission of a satisfactory plan pending purchase of stock. There is no factual basis for such a theory, and it is pertinent to note that such a theory is nowhere asserted or suggested in the original or supplemental findings of the Commission, 8 S. E. C. 893, (R. 63-79, 104), nor in its report on the plan (R. 97), nor in the petition for certiorari, nor in the Commission's statement of the "question presented" for decision by this Court.

The brief now indicates that the Commission's staff at all times opposed any participation by the Class B stock (Brief pp. 13-14, 19). This is not supported by the record. If this Court is to look at the unprinted record, to which many references have been made in the Commission's present brief, the story of the successive plans and the discussions with the staff thereon, will be found beginning at Tr. 2731. As late as May 11, 1939, when the third plan was presented (Tr. 2744) the company was informed by the staff that the Commissioners had discussed the plan and that it appeared sufficiently meritorious to make its filing appropriate (Tr. 2744-6).

The position of the company throughout was that it could not put through a voluntary plan of reorganization without the consent of the Class B stock, and that it was not unfair or inequitable to recognize the voting power of the Class B stock in some small way, as that stock was being asked to consent to a modification of its contractual rights. The company also considered that the Class A stock should have been accorded a larger participation than that finally given it, and this point was always a subject of discussion, ending with a dissent by one Commissioner who considered that the Class A stock should not participate at all. Difficulties presented by the Delaware law also delayed the formulation of the plan finally approved. The novelty of the questions and changes in membership of the Commission and its staff also contributed to delay.

The Court said further:

> "* * * it is admitted that there was a full and free disclosure before any purchases were made, the exercise of the utmost good faith throughout, * * *" (R. 146)
>
> "* * * And yet the Commission proposes to annul, not transactions growing out of an abuse of inside information, but transactions as to which both buyer and seller were equally informed of the facts—not trading designed to take quick profits from short term market fluctuations, but trading for investment by one whose income depended at least in part upon the success of the corporation of which he was an officer." (R. 149)

The Court of Appeals held that no statute, regulation, or rule of common law or equity proscribed such purchases of stock (R. 143), that Congress in enacting the Public Utility Holding Company Act of 1935 had never intended to proscribe an investment made under these circumstances (R. 149), and that the action of the Commission was equivalent to retrospective legislation. (R. 150) The order of the Commission was therefore reversed. (R. 150)

SUMMARY OF ARGUMENT.

No rule of common law or equity has ever prohibited the purchase of stock by an officer or director, nor does any statute prohibit such purchase. When the purchases involved in these proceedings were made no regulation of the Commission indicated that the purchases might be objectionable to the Commission. Purchases of stock by officers and directors should generally be encouraged, whether or not the corporation is in process of reorganization. There was no unfairness or inequity in these particular purchases.

This case arises under the Public Utility Holding Company Act of 1935, and the jurisdiction of the Commission is predicated entirely thereon. The general provisions of Sections 7 and 11 thereof do not contain any reference to

such purchases. But Section 17 of that very statute does deal with purchases of stock by officers and directors. Section 17 provides for reports thereon to the Commission and for recovery by the corporation of profits made by such officers and directors from sales within six months of purchase. The absence of any further requirement, prohibition, or penalty in the statute dealing with the subject shows a Congressional intent to permit officers and directors to purchase and hold such stock freely to the extent that such purchases are not affected by the provisions of Section 17.

The order of the Commission approving a plan of reorganization containing a provision that the preferred stock purchased by the respondents should be treated on a less favorable basis than other preferred stock of the same class is unfair and inequitable to the persons affected and is detrimental to the interest of investors. The entry of such an order went beyond the power imposed in the Commission by Congress.

Only a legislature can adequately determine, after hearings on the subject, whether the prohibition established by Section 17 should be enlarged. The legislature would have to determine whether, in the absence of fraud or inequity, officers and directors should ever be precluded from purchasing stock, and if so when—whether during reorganization, pending reorganization, or always—whether such a prohibition should apply also to majority stockholders, and to members of families of officers, directors, or stockholders, whether such persons should also be prohibited from selling stock that they might own, or whether perhaps they should be required to sell all their stock in order that they might be completely disinterested.

Such legislative action obviously would be prospective in its operation. We submit that the Commission has invaded the legislative field and that its action was equivalent to an attempt to legislate retroactively.

ARGUMENT.

I.

No Rule of Common Law or Equity Prohibited the Purchase of Stock by the Respondents.

A. The Prevailing Doctrine in the Courts Imposes No Legal or Equitable Restriction on Purchases by an Officer or Director from a Shareholder.

An officer or director of a corporation may freely purchase the stock of his corporation from the stockholders, provided only that he is not guilty of fraud or misrepresentation. This is the law of Delaware, where the three corporations involved in this case were organized and pursuant to whose statutes the merger was conducted. *Cahall* v. *Lofland*, 12 Del. Ch. 299, 114 Atl. 224 (1921), aff'd 13 Del. Ch. 384, 118 Atl. 1 (1922); *Dupont* v. *Dupont*, 242 Fed. 98 (D. Del. 1917), 256 Fed. 129, (C. C. A. 3d, 1919), cert. denied, 250 U. S. 642 (1919). Such is the law in the great majority of jurisdictions in this country, and so it is in England and Canada. The authorities are collected in an annotation entitled *Duty of Officer or Director of Corporation Toward One from Whom He Purchases Stock*, 84 A. L. R. 615 (1933). See also 3 Fletcher on Corporations, Sec. 1168; Thompson on Corporations, Sec. 1258; 13 Am. Jur. 962.

The early authority is the case of *Carpenter* v. *Danforth*, 52 Barb. 581 (N. Y. 1868). Other leading decisions include *Bawden* v. *Taylor*, 254 Ill. 464, 98 N. E. 941 (1912); *Blabon* v. *Hay*, 269 Mass. 401, 169 N. E. 268 (1929); *Walsh* v. *Goulden*, 130 Mich. 531; 90 N. W. 406 (1902); *Dutton* v. *Barnes*, 162 Minn. 430, 203 N. W. 414 (1925); *Crowell* v. *Jackson*, 53 N. J. L. 656, 23 Atl. 426 (1891); *Klerlein* v. *Werner*, 307 Pa. 16, 160 Atl. 719 (1932); and *Percival* v. *Wright*, [1902] 2 Ch. 421.*

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*Other jurisdictions which deny the existence of any unusual duty on the part of a director in purchasing stock from a shareholder include Arizona, California, Indiana, Kentucky, Louisiana, Missouri, Rhode Island, Tennessee, Utah, Washington, and West Virginia. 84 A. L. R. 617-618.

The rule is succinctly stated in 3 Fletcher on Corporations, Sec. 1168:

> "By the weight of authority a director or officer has the same right to buy stock from a stockholder of the company as any one else."

As was said by the Illinois Court in *Bawden* v. *Taylor*, *supra*, at page 942:

> "* * * The officers * * * are trustees for the stockholders as a body with respect to the business and property of the corporation, which is under their control and management for the benefit of stockholders generally; but an officer has no control over the shares of the individual stockholder and is not a trustee for such stockholder with respect to his stock. *Officers of a corporation may purchase the stock of stockholders on the same terms and as freely as they might purchase of a stranger.*" (Italics ours.)

The italicized language was recently quoted with approval in *Anchor Realty & Investment Co.* v. *Rafferty*, 308 Ill. App. 484, 32 N. E. (2d) 394, 401 (1941). *Seitz* v. *Frey*, 152 Minn. 170, 188 N. W. 266 (1922), states the same doctrine:

> "* * * a director or officer does not stand in a fiduciary relation to a stockholder in respect to his stock, and *has the same right as any other stockholder to buy stock from or sell stock to another stockholder*". (Italics ours.)

Similar language could be multiplied many times.

It can be said categorically that no court has ever laid down a general restriction against the purchase of stock by officers and directors such as was contained in the opinion and order of the Commission in this case. The prevailing judicial doctrine imposes no restrictions on such transactions other than those ordinarily imposed by the law of torts.

B. The Same Rule Obtains in Suits by Minority Stockholders for the Benefit of the Corporation.

The rule that an officer or director may freely purchase stock in a corporation in the absence of fraud or other inequity obtains not only in suits brought directly by a stockholder vendor for his own benefit against an officer or director but also has been applied in cases where the contention has been made that a constructive trust in favor of the corporation should be imposed upon the stock purchased by officers and directors so that any profit therefrom should be turned over to the corporation, as urged by the Commission in this case.

An interesting case of this sort is *Bisbee* v. *Midland Linseed Products Company*, 19 F. (2d) 24 C. C. A. 8th (1927), cert. den. 275 U. S. 564 (1927). This decision affirmed a dismissal of a bill brought by minority stockholders praying that a constructive trust be imposed upon alleged wrongful profits made by the officers and directors of Midland. Midland was in liquidation. It had ceased business, and its only remaining function was to collect its assets and distribute them to the stockholders. In these circumstances some of its directors and officers organized a corporation which purchased large blocks of the outstanding stock. This was done for the purpose of minimizing the taxes of the participants. The stock so purchased ultimately developed a value considerably in excess of the purchase price, and the contention was made by the plaintiff stockholders that the purchases so made at the instance of the directors should be considered in trust for the corporation. It was held, however, that the directors were under no duty to account to the corporation for such profits, the court saying:

> "There can be no question but that the directors, officers, majority stockholders, and those in control of the liquidation of the Midland occupied towards the corporation and its stockholders, in respect to the business and property of the corporation, a fiduciary relation or sub modo trusteeship, and could not deal with the prop-

erty of the corporation for their own personal benefit or advantage. (citing cases.)

"Those in control of the liquidation of the Midland owed this duty to the company and the minority stockholders. But their duty as trustees with respect to the business and property of the corporation did not extend to the outstanding stock of the corporation, for the reason that such stock is the individual property of the respective stockholders, and is not in any sense property of the corporation. The corporation as such has no interest in the outstanding stock, or in dealings between the stockholders, with respect thereto. Each stockholder has the right to buy stock in the corporation, or to sell his stock as he sees fit, and no stockholder, nor group of stockholders, has any pecuniary interest in the stock of the others, and has no interest in any gain or loss that may be realized or sustained by such others in dealing with or disposing of their stock. *No trust duty rests upon the directors, officers, majority stockholders, or liquidators of a corporation, in behalf of any other stockholders or set of stockholders, with respect to dealings between them in buying or selling stock in the corporation, unless some situation exists which makes it inequitable for such officer to buy the stock in question.* (citing cases)" (Italics ours).

Respondents maintain that no court of equity would decree in a suit by the stockholders of Federal that the respondents should be held trustees ex maleficio of the stock purchased and therefore liable to turn it over to the corporation, since there has been no showing of fraud, concealment or any unfairness to either the body of the stockholders, or the corporation.

C. The Only Dissent from the Prevailing Doctrine Has Been Directed Toward Its Failure to Impose a Duty of Disclosure on the Director.

Dissent from the prevailing doctrine has centered solely on the issue of whether or not an officer or director is under a duty to disclose to the seller information known to the

officer or director but not known to the stockholder who is about to sell his shares. A few courts purport to require that the director inform the seller of important information affecting the value of the corporation's shares of which the stockholder is ignorant. *Oliver* v. *Oliver*, 118 Ga. 362, 45 S. E. 232 (1903); *Stewart* v. *Harris*, 69 Kans. 498, 77 Pac. 277 (1904).

These few states hold that in the absence of disclosure of relevant important information the stockholder who sold may have an accounting to recover any profit which accrued to the purchasing director. This minority rule—requiring disclosure—has been rejected by all the important financial states. But even this rule does not prohibit purchases, it merely requires disclosure.

What has sometimes been considered a third view, referred to as the "special facts" doctrine, originated with the case of *Strong* v. *Repide*, 213 U. S. 419 (1909). This doctrine is that although ordinarily a director is under no duty to disclose information to the stockholder from whom he is purchasing the stock, it may be that because of unusual circumstances surrounding the transaction the director must make a full disclosure. Again it must be emphasized that the point under consideration is whether or not there is a duty of disclosure; in no case has there been a suggestion that there is a duty to refrain from purchasing if there has been no failure to disclose. Actually every case classified under the "special facts" doctrine may be explained on the basis of traditional legal principles, such as govern cases of fraud, misrepresentation, etc. Thus, it was recently stated in *Fischer* v. *Guaranty Trust Co.*, 259 App. Div. 176, 18 N. Y. S. (2nd) 328, 333 (1940):

> "* * * I believe it will be found that in every instance where a director has been held accountable to the stockholder, in an action arising out of negotiations resulting in the purchase of his stock, not only the element of active fraud of the director existed, but the reliance of the stockholder thereon as the inducement to part with the stock also existed."

D. Respondents Have Withheld No Information Which Should Have Been Disclosed.

The facts in reference to the purchases have been given in this brief at page six, and will not be repeated. Wide publicity was given to the financial condition of the company and the development of the successive plans.

There has been no contention by the Commission that there was a failure to disclose any circumstance which would have affected the value of the stock. The Commission's decision was based squarely on the assumption that there should be an "inflexible rule" that officers and directors of a corporation may not purchase its stock while a reorganization plan is pending. The Commission stated,

> "* * * honesty, full disclosure and purchase at a fair price do not take the case outside the rule." (R. 73)

Respondents maintain that there has never been such an "inflexible rule", and that the Commission had no authority to promulgate such a rule in this case.

II.

Neither Section 7 Nor Section 11 of The Public Utility Holding Company Act of 1935 Empowers the Commission to Require the Respondents to Surrender Stock Purchased by Them While Reorganization Proceedings Were Pending.

Section 7(e) of the Public Utility Holding Company Act of 1935 makes it mandatory* upon the Commission to permit a declaration filed under Section 6 to become effective regarding the exercise of a privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security unless the Commis-

* Subject to requirements not here material.

sion finds that this will result in an unfair and inequitable distribution of voting power or

> "• • • is otherwise detrimental to the public interest or the interest of investors or consumers".

Section 11(e) of the Act has as one of its standards that the plan be

> "• • • fair and equitable to the persons affected • • •"

The majority of the Commission properly treated the case as arising under Section 7 (R. 118, 122), and merely remarked that the plan must also

> "be considered in the light of the standards of Section 11(e)". (R. 122)

This proceeding was thus under Section 7, but for the purposes of this case whatever difference there may be between "detrimental to the interest of investors" and "fair and equitable to the persons affected" appears immaterial. The respondents contend that for the Commission to treat the stock purchased by them during the period when the reorganization plan was pending on a different basis from other stock of the same class would be "detrimental to the interest of investors" under Section 7 and also would not be "fair and equitable to the persons affected by the plan" as contemplated by Section 11.

There is certainly nothing in the language of the statute which expressly gives the Commission power to treat stock purchased by officers and directors during a period when a reorganization plan is pending on a different basis from other stock of the same class. And it would seem that when the Commission deals with questions concerning rights and priorities of classes of stockholders, it should take those rights and priorities as they exist under state law. There is no other source for rights and priorities. *Erie Railroad* v. *Tompkins*, 304 U. S. 64 (1938). Heretofore, equality

of treatment among stockholders of the same class has been considered fundamental in any plan of reorganization under state law. A stockholder of a class is entitled to the same rights as any other stockholder of the same class. By the use of such general language as "detrimental to the interest of investors" and "fair and equitable to the persons affected", Congress surely did not intend to authorize the Commission to compel discrimination among holders of securities of a single class under a theory never heretofore applied.

Rights of stockholders may be modified by merger or consolidation, by reduction of capital, or by amendment to the corporate charter in various ways. Authority for such proceedings is found in the statutes of the state under which the particular corporation is organized and in the court decisions construing such statutes. There have been innumerable proceedings which have modified rights of stockholders, but we have found no decision where it has ever been held that while such proceedings are pending officers and directors may not purchase stock of the corporation, and we respectfully urge that there is no basis in principle or authority for an attempted distinction between a case involving a corporation in voluntary reorganization and a corporation for which no such reorganization is contemplated.

The fact that a registered public utility holding company is required to submit its plan to the Commission for a report and is required to file a declaration under Section 7 before the rights of its stockholders can be modified seems to afford even less basis for a rule prohibiting stock purchases by officers and directors than during a reorganization outside of the Act. The plan may not be submitted to the stockholders and no proxies may be solicited unless and until the Commission has permitted the declaration to become effective and has made a report on the plan, which report must be transmitted to all of the stockholders with any solicitation of assent. Finally the stockholders must

vote on the plan. There is no occasion for the promulgation of a new principle of corporate law to protect stockholders in such cases.

III.

Section 17 of the Public Utility Holding Company Act of 1935 Recognizes the Right of Respondents to Purchase Stock.

As we have shown, the courts have not restricted or prohibited the purchase of stock in a corporation by its officers and directors. The only qualification which need be made to this statement is that the courts of a few states have held that a director is under a duty to disclose to the selling shareholder any special information which the director has with reference to the value of the stock. The important financial legislation in the period from 1933 to 1935, however, imposed certain new requirements on directors of corporations listed on a stock exchange and on directors of public utility holding companies.

These restrictions are embodied in Section 16 of the Securities Exchange Act of 1934* and Section 17 of the Public Utility Holding Company Act of 1935. Section 16 of the 1934 Act, which is the counterpart of Section 17 of the 1935 Act, "* * * aroused great controversy", Tracy and MacChesney, *The Securities Exchange Act of 1934*, 32 Mich. L. Rev. 1025, 1056 (1934). Extended hearings were held on this portion of the Act. Throughout the discussion it was recognized that the proposed legislation would be an innovation. As one writer put it:

> "The Section has established for the management and those in control of the larger corporations of the United States a new standard of conduct far beyond that required by prior statutory or case law." Yourd, *Trading in Securities by Directors, Officers and Stock-*

* 48 Stat. 896, 15 U. S. C. Sec. 78(p).

holders: Section 16 of the Securities Exchange Act, 38 Mich. L. Rev. 133 (1939).

These sections, like other portions of the acts of which they are a part, impose on the management a definite duty of disclosure. Purchase of the stock of the company by its officers and directors must be reported to the Commission. Other sections provide for periodic financial reports and the disclosure of other information which might in the past have been used by directors or officers for their personal gain. See MacChesney and O'Brien, *Full Disclosure Under the Securities Act*, 4 Law and Contemporary Problems 143 (1937); MacChesney, *Further Developments in "Disclosure" Under the Securities Act*, 33 Ill. L. Rev. 145 (1939).

Section 17 of the Public Utility Holding Company Act of 1935 provides for forfeiture to the corporation of "any profit realized by any such officer or director from any purchase and sale, or any sale and purchase, of any security of such registered holding company or any subsidiary company thereof *within any period of less than six months*". The statute says that this is "for the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company". In this section, Congress went beyond the imposition of a duty to disclose, and placed a definite and certain limitation on the right to profit from trading in the securities of the corporation.

The legislative history shows that Congress considered that, through the provisions of Section 16 of the 1934 Act and Section 17 of the 1935 Act, the purchase of securities by the management had been sufficiently regulated to eliminate the abuses indicated at the hearings. Thus, in Senate Report No. 792, 73rd Congress, page 9, with reference to what became Section 16 of the 1934 Act, the committee stated:

> "Such a provision will render difficult or impossible the kind of transactions which were frequently de-

scribed to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others."

Again, at page 20, with reference to the six-month provision, the report states that:

"The expressed purpose of this provision is to prevent the unfair use of inside information."

At page 68 of the Senate Report No. 1455, 73rd Congress, 2nd Session, the provisions of Section 16 are analyzed under the heading "Regulation of Market Activities of Officers, Directors and Principal Stockholders". This would seem to indicate that Section 16 expressed the full extent of Congress' intent to change the law with respect to purchase of stock by management.

At page 40 of Senate Report No. 621, 74th Congress, which is an analysis of the bill which became the Public Utility Holding Company Act of 1935, it is said:

"This section corresponds to section 16 of the Securities Exchange Act of 1934 and covers the transactions by officers, directors, and affiliates of registered holding companies in the securities of those companies and of subsidiary companies thereof."

From this legislative history it appears that Congress had no intention to create any other prohibition against or limitation on purchase of corporate securities by the officers and directors of a corporation. The proposition acquires further support in view of the cause of action given to the issuing corporation to recover any profits realized within a period of six months. It seems clear that Congress did not intend that profits from purchases by management should result to the corporation, except in those specified instances where the profit was realized within *six months* of the date of purchase. Yet the Commission is now attempting to re-

quire that management give up stock acquired during a period of two and a half years. Since the problem of purchases of securities by management was expressly covered by Section 17, well recognized tenets of statutory construction require that no further prohibition or limitation be read into the same statute through the generalities of Section 7 or Section 11. Crawford on Statutory Construction, Sec. 195 (1940).

As late as August 7, 1941, the Commission itself stated in its *Report on Proposals for Amendments to the Securities Act of 1933 and Exchange Act of 1934*, at page 82:

> "It is only where the insider makes a profit within the relatively short period of six months that his profit is required to be turned over to the corporation."

One commentator stated:

> "As long as equity securities are acquired for the purposes of investment or control, Section 16(b) is not concerned with the circumstances of the acquisition". Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 Mich. L. Rev. 133, 148 (1939).

The Public Utility Holding Company Act of 1935 is the *only* statute directly involved in this case. The entire jurisdiction of the Commission in regard to public utility holding companies is derived from that Act. The procedure for filng a declaration under Section 6, the action by the Commission under Section 7, and the effect of Section 11, is all determined by the same statute. And it is in *this same* statute that Section 17 provides that any profit realized by an officer or director by purchase and sale of its stock consummated within six months shall be forfeited to the corporation "for the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company".

The Court need not go beyond this one statute. If Congress had wished to bring about the result requested by the Commission in this proceeding, a provision would have been included in the Public Utility Holding Company Act of 1935 that officers and directors who purchase stock while a plan is under consideration by the Commission shall be required to surrender such stock as a prerequisite to the approval of such a plan. But no such provision was included in the statute. As the Court of Appeals said:

> "Clearly, the enactment of Section 17 was intended to restrict a recognized existing right and place a definite and certain limitation on its exercise. But subject to its provisions, officers and directors of a corporation are permitted to deal in its securities." (R. 145)

IV.

The Authorities Cited on Behalf of the Commission do not Support a Restriction of the Right of Respondents to Purchase Stock.

The theory of the Commission was set forth as follows:

> "Corporate directors are fiduciaries * * * in the process of formulation of a 'voluntary' reorganization plan, the management of a corporation occupies a fiduciary position toward all of the security holders to be affected, */ * * A trustee may not 'become the purchaser of the property which he represents' or any portion of it though he has done so for a fair price without fraud at a public sale * * * accordingly, honesty, full disclosure and purchase at a fair price do not take the case outside the rule." (R. 72, 73)

The Commission stated that a trustee of an express trust is prohibited from purchasing the trust res "though he has done so at a fair price without fraud, at a public sale", and by "analogy" from certain cases arising under the bankruptcy laws, the Commission decided that the same rule should be applied in the case at bar. (R. 77)

By stating that "corporate directors are fiduciaries" the Commission does not greatly advance the argument. The question is: to whom do the directors owe an obligation, and what is the extent of that obligation.

> "Although it is often said that a director of a corporation occupies the position of a trustee with respect to the corporation, closer analysis shows that this is far from accurate. A trustee of an express trust may not ordinarily buy trust property; he may not sell to the trust estate any property he owns or in which he has a personal interest; nor may he borrow trust funds for his own purposes. On the other hand a director may either buy from or sell to the corporation, provided that he can prove the price is fair; in many instances, borrowing corporate funds is permissible. These departures from the norm of a trustee's conduct are not asserted as exceptions to his character as a trustee, but rather are put forth as ordinary instances of his duties and powers. Accordingly, while a director bears some relation to a trustee, it is impossible to base an accurate estimate of his powers, duties, or liabilities upon the tenuous theory that he is a 'trustee'." 39 Col. L. Rev. 219 (1939).

The Commission seeks support for its contention in *Pepper* v. *Litton*, 308 U. S. 295 (1939), *American Ins. Co.* v. *Avon Park*, 311 U. S. 138 (1940), and *Woods* v. *City Bank Co.*, 312 U. S. 262 (1941). The *Pepper* case involved a "planned and fraudulent scheme" by the dominant stockholder of a corporation to defraud other creditors in prosecuting an alleged claim for accrued salary. The *Avon Park* case involved a fiscal agent of a municipality who was also a creditor, and who had concealed this dual relationship from other creditors. In the *Woods* case, claimants who had represented conflicting interests were denied compensation. There is nothing in these decisions which modifies the well established rule that stock of a corporation may be purchased by its officers and directors.

These and the other cases cited by the Commission involve situations where there has been fraud, bribery, or other

inequity, or where the Court has applied provisions of the Bankruptcy Act not involved in this case.*

These provisions of the Bankruptcy Act obviously are not directly applicable to the present case, which arises under the Public Utility Holding Company Act of 1935. Furthermore, the situation in the present case is quite different. In cases arising under the Bankruptcy Act the agent, attorney, trustee, or committee acts by virtue of an express authorization from the creditor or stockholder given in the case, and usually has broad and complete authority even to the point of voting finally on behalf of such creditor or stockholder. Here the officers and directors of the corporation bear no such relationship to the stockholders. They have not obtained from, nor can they solicit or obtain from, any stockholder a proxy or authorization. They act merely in their general capacity as officers and directors. As such they have no standing in the proceedings and take no direct part therein. The corporation proposes the plan.** It must

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* Fraud: *United States* v. *Buckner*, 108 F. (2d) 921, (C. C. A. 2d. 1940), cert. den. 309 U. S. 669 (1940); *Kroger* v. *Jaburg*, 231 App. Div. 641, 248 N. Y. S. 387 (1931); *Miner* v. *Belle Isle Ice Co.*, 93 Mich. 97, 53 N. W. 218 (1892); *Tower Hill-Connellsville Coke Co.* v. *Piedmont Coal Co.*, 64 F. (2d) 817 (C. C. A. 4th 1933), cert. den. 290 U. S. 675; *Wardell* v. *Railroad G.*, 103 U. S. 651 (1880). A bribe: *Lum* v. *McEwen*, 56 Minn. 278, 57 N. W. 662 (1894). Corporate officers and directors attempting to prove in full claims bought at discount when corporation was insolvent. *In Re Norcor Manufacturing Co.*, 109 F. (2d) 407, (C. C. A. 7th 1940); *In re McCrory Stores Corp.*, 12 F. Supp. 267, (S. D. N. Y. 1935). Bankruptcy Act applied: *Taylor* v. *Standard Gas and Electric Co.*, 306 U. S. 307 (1939); *Otis & Co.* v. *Insurance Bldg. Corp.*, 110 F. (2d) 333, (C. C. A. 1st 1940); *In re Mountain States Power Co.*, 118 F. (2d) 405, (C. C. A. 3d, 1941); *In re Republic Gas Corp.*, 35 F. Supp. 300, (S. D. N. Y. 1936), *In re Paramount Publix Corp.*, 12 F. Supp. 823 (S. D. N. Y. 1935).

** The theory of the Commission's brief is that "the management" proposes the plan as trustee for the stockholders. Section 7 of the Public Utility Holding Company Act of 1935, however, provides that the *corporation* propose the plan. The corporation, as in all cases, acts through its officers and such action is presumably authorized by the directors. But the fact that the directors have continued to exercise the duties of their office should not be held to

be approved by the Commission, and finally adopted by the stockholders.

As the Court of Appeals said:

> "... The difference between petitioners and a stockholders' committee created to protect its members in winding up or reorganizing an insolvent corporation is striking and obvious. Here, as to the purchases made by petitioners, there is no express trust in which petitioners are trustees, nor are petitioners agents of, nor do they speak for, the shareholders in the proceedings before the Commission. They merely propose the plan—as to which, of course, honesty and fair dealing must be shown—and in the present instance is admitted. The approval is for the Commission, and the confirmation is by act of the stockholders in accordance with State law and in which two-thirds must agree, with the right on the part of a dissenting stockholder to have an appraisement and the value of his shares in cash. The directors' functions are thus wholly different from those of the reorganization committees, to which the courts apply the rule of trustee and beneficiary." (R. 147, 148)

V.

The Commission Has Attempted to Invade The Legislative Field.

As we have pointed out in this brief, the law has always been that officers and directors of a corporation may freely purchase its stock. The only difference in the decisions has been in the extent to which the courts require disclosure to the seller of particular facts known to the officers or directors.

The *legislature* has changed this law in two respects, by providing in Section 17 of the Public Utility Holding Com-

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impose a fiduciary relationship between directors and stockholders never before recognized and not created by any authorization from the stockholders to the directors in the particular case.

pany Act of 1935, that officers and directors shall report their holdings, purchases and sales, and that they shall account to the corporation for any profits made upon sales within six months of purchase. So far has the legislature changed the common law that officers and directors of a corporation may purchase its stock, and no further. If there is to be any further prohibition it should again be made by the legislature.

Of course, if a case involves fraud or actual inequity the courts can always resolve the question fairly in view of the particular facts. This is what was done in the many cases cited on the petitioners' brief. But in a case where there has been full disclosure and complete compliance with the statute in reporting the purchases, and where there is no fraudulent element whatever, how are the courts to determine, in the absence of legislation, what the standard is to be?*

Shall officers and directors hereafter be precluded from purchasing stock at all? Or shall they be precluded only when a plan or reorganization is under consideration by the Commission? Or shall the prohibition extend to the period when the filing of a plan of reorganization may have been under consideration by the officers and directors?

Shall the prohibition apply to officers and directors only? Or to stockholders, and if so to what stockholders? Shall the prohibition apply to wives or members of the families of directors, officers, or stockholders, and if so in what degree of relationship?

Shall the prohibition apply to corporations in which officers or directors own stock? Or to corporations in which members of the families of officers or directors own stock?**

Shall officers or directors be prohibited from selling any stock that they already own? If they are to be precluded

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* Congress might just as logically have made the period in Section 17 five or seven months instead of six months.

** Respondent Chenery Corporation is, of course, not an officer or director.

from buying because they have information, perhaps they should be precluded from selling. Or, in addition to prohibiting them from purchasing additional stock, shall officers and directors be required to sell *all* their stock so that their actions thereafter will be completely disinterested?

A corporate officer or director almost invariably is better acquainted with the financial status of the corporation than are other stockholders. He can predict more accurately the possible future trends of corporate profits. He can usually tell better than anyone else when it is best to buy or when it is best to sell the stock of the corporation. All of these considerations might suggest a flat prohibition of purchase of stock by the management of a corporation, although there is less reason for prohibiting such purchases while proceedings are pending before the Commission, with the publicity incident thereto, than when the corporation is quietly engaged in the normal conduct of its affairs.

On the other hand, there are equally obvious reasons for permitting, and indeed, encouraging, the participation in ownership of a corporation by its management. The very desire for personal gain should lead to a more conscientious and energetic prosecution of corporate affairs. The fact that the management is in the same class as other shareholders would tend to lead to a fairer treatment of these other shareholders. Additional examples are readily apparent. "It is a common statutory provision that the directors must be share holders in the corporation", 83 U. Pa. L. Rev. 56, 57 (1939). And in a very recent note in 54 Harv. L. Rev. 1191, 1196 (May 1941) it is stated that "Theoretically it is desirable that the management have a proprietary interest in the corporation." We respectfully submit that purchases of stock of officers and directors should generally be encouraged whether or not the corporation is in process of reorganization.

All of these arguments, pro and con, are such as should properly be addressed to a legislative body, in order that the public policy involved may be carefully weighed, and

that all parties concerned may be given notice of any proposed change in the law. Such arguments actually were presented to Congress at the time of the enactment of the Public Utility Holding Company Act of 1935 and the Securities Exchange Act of 1934, and as a result, Congress reached a compromise position between complete freedom for management to purchase shares and complete prohibition. This compromise is set forth in Section 17 of the Public Utility Holding Company Act.

Any action by the legislature is prospective in its operation. Section 17 did not apply to transactions completed prior to the enactment of the statute. But here, without warning, the Commission suddenly attempted to promulgate a rule which would have deprived the petitioners of their ownership in stock which they had purchased when there had been no suggestion from any quarter that their conduct might be criticized.

Certainly no one could have advised the respondents, during the period from November 8, 1937, to June 29, 1940, during which the plans of merger and reorganization to eliminate the capital deficit were before the Commission, that they might not purchase shares of the company. No advance warning of the unprecedented decision of the Commission was given. Throughout this period the members of the staff of the Commission were fully cognizant of these purchases, yet no suggestion was made until the Commission's tentative opinion of June 29, 1940, that purchasing the preferred stock of the company was in any respect opposed to the standards laid down by Congress and the courts. For an administrative body to formulate a new principle and then to apply it retroactively to transactions which had been reported to that body and which had not been objected to is a harsh procedure.

This point was summarized by the Court of Appeals (R. 149) as follows:

> "In expressing this opinion, we are not saying that the Commission's view is not directed to a desirable

end. As to that, opinions of men of experience and probity and judgment will differ widely. But, if the Commission's objective is to be attained, it should be only after the pros and cons have been carefully weighed in their relation, respectively, to the dangers and the benefits, and the scales should be controlled by Congress and not by the Commission. In short, all that we hold is that this vital question of policy is one for the Congress and not for the Commission. Until Congress acts to change the standard it has expressly set up in the Act, action by the Commission to expand or enlarge its terms, and to make such expansion or enlargement apply to transactions three years old, is we think, with great deference to the Commission, neither more nor less than retrospective legislation."

CONCLUSION.

The respondents therefore pray that the judgment of the United States Court of Appeals for the District of Columbia be affirmed.

Respectfully submitted,

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APPENDIX.

Public Utility Holding Company Act of 1935.*

Sec. 6. (a) Except in accordance with a declaration effective under section 7 and with the order under such section permitting such declaration to become effective, it shall be unlawful for any registered holding company or subsidiary company thereof, by use of the mails or any means or instrumentality of interstate commerce, or otherwise, directly or indirectly (1) to issue or sell any security of such company; or (2) to exercise any privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security of such company.

* * *

Sec. 7. (a) A registered holding company or subsidiary company thereof may file a declaration with the Commission, regarding any of the acts enumerated in subsection (a) of section 6, * * *.

* * *

(d) If the requirements of subsections (c) and (g) are satisfied,** the Commission shall permit a declaration regarding the issue or sale of a security to become effective unless the Commission finds that—

* * *

(6) the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers.

(e) If the requirements of subsection (g) are satisfied,** the Commission shall permit a declaration to become effective regarding the exercise of a privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security unless the Commission finds that such exercise of such privilege or right will result in an unfair or inequitable distribution of voting power among holders of the securities of the declarant or is otherwise detrimental to the public interest or the interest of investors or consumers.

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* 49 Stat. 803, 15 U. S. C. Sec. 79.

** Subsection (c) and (g) are not material.

Sec. 11(b) It shall be the duty of the Commission, as soon as practicable after January 1, 1938:

* * *

(2) To require by order, after notice and opportunity for hearing, that each registered holding company, and each subsidiary company thereof, shall take such steps as the Commission shall find necessary to ensure that the corporate structure or continued existence of any company in the holding-company system does not unduly or unnecessarily complicate the structure, or unfairly or inequitably distribute voting power among security holders, of such holding-company system. In carrying out the provisions of this paragraph the Commission shall require each registered holding company (and any company in the same holding-company system with such holding company) to take such action as the Commission shall find necessary in order that such holding company shall cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary company which is a holding company. Except for the purpose of fairly and equitably distributing voting power among the security holders of such company, nothing in this paragraph shall authorize the Commission to require any change in the corporate structure or existence of any company which is not a holding company, or of any company whose principal business is that of a public-utility company.

* * *

(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control, securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in

accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed.

* * *

Sec. 17. (a) Every person who is an officer or director of a registered holding company shall file with the Commission in such form as the Commission shall prescribe (1) at the time of the registration of such holding company, or within ten days after such person becomes an officer or director, a statement of the securities of such registered holding company or any subsidiary company thereof of which he is, directly or indirectly, the beneficial owner, and (2) within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, a statement of such ownership as of the close of such calendar month and of the changes in such ownership that have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by any such officer or director by reason of his relationship to such registered holding company or any subsidiary company thereof, any profit realized by any such officer or director from any purchase and sale, or any sale and purchase, of any security of such registered holding company or any subsidiary company thereof within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the holding company or subsidiary company in respect of the security of which such profit was realized, irrespective of any intention on the part of such officer or director in entering into such transaction to hold the security purchased or not to repurchase the security sold for a period of more than six months.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1942

No. 254.

SECURITIES AND EXCHANGE COMMISSION,
Petitioner,

vs.

CHENERY CORPORATION, H. M. ERSKINE, R. H. NEILSON, *et al.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

BRIEF ON BEHALF OF FEDERAL WATER AND GAS CORPORATION, AS INTERVENOR

ALLEN S. HUBBARD,
Attorney for Federal Water and Gas Corporation.

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BRIEF ON BEHALF OF FEDERAL WATER AND GAS CORPORATION, AS INTERVENOR

OPINIONS BELOW

The opinions of the Court of Appeals (R. 139-155) are reported in 128 F. (2d) 303. The Findings and Opinion of the Commission (R. 63-79, 115-132) are reported in 8 S. E. C. 893. The Supplemental Findings and Opinion of the Commission (R. 104-113) and the Report of the Commission on a Plan of Reorganization (R. 97-104) are reported in S. E. C. Holding Company Act Release No. 3023.

JURISDICTION

The judgment of the Court of Appeals was entered April 27, 1942 (R. 155). The petition for a writ of certiorari was filed July 25, 1942, and was granted October 12, 1942 (R. 159). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, made applicable by Section 24(a) of the Public Utility Holding Company Act of 1935.

STATEMENT

The following brief, which was submitted to the Court below, is submitted herewith on behalf of Federal Water and Gas Corporation, as intervener:

> "Federal Water and Gas Corporation filed a petition* with this Court for leave to intervene in the above entitled proceeding setting forth its interest in the proceeding as follows:
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> 'IV. Federal is interested in the relief to which petitioners herein are entitled if it should be held that paragraph FOURTH(d) of the merger agreement was in violation of the rights of petitioners as stockholders of Federal and believes that it should be made a party to this proceeding and that this Court should have jurisdiction over it. If said paragraph FOURTH(d) of the merger agreement was not in accordance with the legal rights of petitioners and they were legally entitled to receive the same treatment by the reorganization plan as was accorded to other

*Copy of this petition is incorporated in the printed record (pp. 133-137). A copy was annexed as an appendix to the intervener's brief in the Court below.

holders of stock of Federal of the same class. Federal desires to correct the error by the issuance of its shares of authorized but unissued stock to the petitioners herein so that they will receive such stock upon the same terms as stock was offered to other stockholders of the same class by the merger agreement.'

Since no contention has been made by either of the original parties to this proceeding that the error, if any, in paragraph FOURTH(d) of the merger agreement cannot be corrected in the manner set forth in the above quoted section of the petition for leave to intervene, no useful purpose would be served by extending this brief."

Respectfully submitted,

ALLEN S. HUBBARD,
Attorney for Federal Water and Gas Corporation.

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SUPREME COURT OF THE UNITED STATES.

No. 254.—October Term, 1942.

Securities and Exchange Commission, Petitioner, *vs.* Chenery Corporation, H. M. Erskine, R. H. Neilson, et al.	On Writ of Certiorari to the United States Court of Appeals for the District of Columbia.

[February 1, 1943.]

Mr. Justice Frankfurter delivered the opinion of the Court.

The respondents, who were officers, directors, and controlling stockholders of the Federal Water Service Corporation (hereafter called Federal), a holding company registered under the Public Utility Holding Company Act of 1935, c. 687, 49 Stat. 803, 15 U. S. C. § 79, brought this proceeding under § 24(a) of the Act to review an order made by the Securities and Exchange Commission on September 24, 1941, approving a plan of reorganization for the company. Under the Commission's order, preferred stock acquired by the respondents during the period in which successive reorganization plans proposed by the management of the company were before the Commission, was not permitted to participate in the reorganization on an equal footing with all other preferred stock. The Court of Appeals for the District of Columbia, with one judge dissenting, set the Commission's order aside, 128 F. 2d 303, and because the question presented looms large in the administration of the Act, we brought the case here. 317 U. S. —.

The relevant facts are as follows. In 1937 Federal was a typical public utility holding company. Incorporated in Delaware, its assets consisted of securities of subsidiary water, gas, electric, and other companies in thirteen states and one foreign country. The respondents controlled Federal through their control of its parent, Utility Operators Company, which owned all of the outstanding shares of Federal's Class B common stock, representing the controlling voting power in the company. On November 8, 1937, when Federal registered as a holding company under the Public Utility Holding Company Act of 1935, its management filed a plan for

reorganization under §§ 7 and 11 of the Act, the relevant portions of which are copied in the margin.[1] This plan, as well as two other plans later submitted by Federal, provided for participation by Class B stockholders in the equity of the proposed reorganized company. This feature of the plans was unacceptable

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1 "SEC. 7. (a) A registered holding company or subsidiary company thereof may file a declaration with the Commission, regarding any of the acts enumerated in subsection (a) of section 6, in such form as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. Such declaration shall include—

"(1) such of the information and documents which are required to be filed in order to register a security under section 7 of the Securities Act of 1933, as amended, as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers; and

"(2) such additional information, in such form and detail, and such documents regarding the declarant or any associate company thereof, the particular security and compliance with such State laws as may apply to the act in question as the Commission may by rules and regulations or order prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers. . . .

"(d) If the requirements of subsections (c) and (g) are satisfied, the Commission shall permit a declaration regarding the issue or sale of a security to become effective unless the Commission finds that—

. . . . . .

"(6) the terms and conditions of the issue or sale of the security are detrimental to the public interest or the interest of investors or consumers.

"(e) If the requirements of subsection (g) are satisfied, the Commission shall permit a declaration to become effective regarding the exercise of a privilege or right to alter the priorities, preferences, voting power, or other rights of the holders of an outstanding security unless the Commission finds that such exercise of such privilege or right will result in an unfair or inequitable distribution of voting power among holders of the securities of the declarant or is otherwise detrimental to the public interest or the interest of investors or consumers.

"(f) Any order permitting a declaration to become effective may contain such terms and conditions as the Commission finds necessary to assure compliance with the conditions specified in this section. . . .

"SEC. 11. (a) It shall be the duty of the Commission to examine the corporate structure of every registered holding company and subsidiary company thereof, the relationships among the companies in the holding company system of every such company and the character of the interests thereof and the properties owned or controlled thereby to determine the extent to which the corporate structure of such holding company system and the companies therein may be simplified, unnecessary complexities therein eliminated, voting power fairly and equitably distributed among the holders of securities thereof, and the properties and business thereof confined to those necessary or appropriate to the operations of an integrated public-utility system. . . .

"(e) In accordance with such rules and regulations or order as the Commission may deem necessary or appropriate in the public interest or for the protection of investors or consumers, any registered holding company or any subsidiary company of a registered holding company may, at any time after January 1, 1936, submit a plan to the Commission for the divestment of control securities, or other assets, or for other action by such company or any subsidiary company thereof for the purpose of enabling such company or any

to the Commission, and all were ultimately withdrawn. On March 30, 1940, a fourth plan was filed by Federal. This plan, proposing a merger of Federal, Utility Operators Company, and Federal Water and Gas Corporation, a wholly-owned inactive subsidiary of Federal, contained no provision for participation by the Class B stock. Instead, that class of stock was to be surrendered for cancellation, and the preferred and Class A common stock of Federal were to be converted into common stock of the new corporation. As the Commission pointed out in its analysis of the proposed plan, "except for the 5.3% of new common allocated to the present holders of Class A stock, substantially all of the equity of the reorganized company will be given to the present preferred stockholders."

During the period from November 8, 1937, to June 30, 1940, while the successive reorganization plans were before the Commission, the respondents purchased a total of 12,407 shares of Federal's preferred stock. (The total number of outstanding shares of Federal's preferred stock was 159,269.) These purchases were made on the over-the-counter market through brokers at prices lower than the book value of the common stock of the new corporation into which the preferred stock would have been converted under the proposed plan. If this feature of the plan ~~were~~ had been approved by the Commission, the respondents through their holdings of Federal's preferred stock would have acquired more than 10 per cent of the common stock of the new corporation. The respondents frankly admitted that their purpose in buying the preferred stock was to protect their interests in the company.

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subsidiary company thereof to comply with the provisions of subsection (b). If, after notice and opportunity for hearing, the Commission shall find such plan, as submitted or as modified, necessary to effectuate the provisions of subsection (b) and fair and equitable to the persons affected by such plan, the Commission shall make an order approving such plan; and the Commission, at the request of the company, may apply to a court, in accordance with the provisions of subsection (f) of section 18, to enforce and carry out the terms and provisions of such plan. If, upon any such application, the court, after notice and opportunity for hearing, shall approve such plan as fair and equitable and as appropriate to effectuate the provisions of section 11, the court as a court of equity may, to such extent as it deems necessary for the purpose of carrying out the terms and provisions of such plan, take exclusive jurisdiction and possession of the company or companies and the assets thereof, wherever located; and the court shall have jurisdiction to appoint a trustee, and the court may constitute and appoint the Commission as sole trustee, to hold or administer, under the direction of the court and in accordance with the plan theretofore approved by the court and the Commission, the assets so possessed. . . ."

In ascertaining whether the terms of issuance of the new common stock were "fair and equitable" or "detrimental to the interests of investors" within § 7 of the Act, the Commission found that it could not approve the proposed plan so long as the preferred stock acquired by the respondents would be permitted to share on a parity with other preferred stock. The Commission did not find fraud or lack of disclosure, but it concluded that the respondents, as Federal's managers, were fiduciaries and hence, under a "duty of fair dealing" not to trade in the securities of the corporation while plans for its reorganization were before the Commission. It recommended that a formula be devised under which the respondents' preferred stock would participate only to the extent of the purchase prices paid plus accumulated dividends since the dates of such purchases. Accordingly, the plan was thereafter amended to provide that the preferred stock acquired by the respondents, unlike the preferred stock held by others, would not be converted into stock of the reorganized company, but could only be surrendered at cost plus 4 per cent interest. The Commission, over the respondents' objections, approved the plan as thus amended, and it is this order which is now under review.

We completely agree with the Commission that officers and directors who manage a holding company in process of reorganization under the Public Utility Holding Company Act of 1935 occupy positions of trust. We reject a lax view of fiduciary obligations and insist upon their scrupulous observance. See *Wormley* v. *Wormley*, 8 Wheat. 421, 441; *Southern Pacific Co.* v. *Bogert*, 250 U. S. 483, 487-88; and see Stone, *The Public Influence of the Bar*, 48 Harv. L. Rev. 1, 8-9. But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?

The Commission did not find that the respondents as managers of Federal acted covertly or traded on inside knowledge, or that their position as reorganization managers enabled them to purchase the preferred stock at prices lower than they would otherwise have had to pay, or that their acquisition of the stock in any way prejudiced the interests of the corporation or its stockholders. To be sure, the new stock into which the respondents' preferred stock would be converted under the plan of reorganization would have a

book value—which may or may not represent market value—considerably greater than the prices paid for the preferred stock. But that would equally be true of purchases of preferred stock made by other investors. The respondents, the Commission tells us, acquired their stock as the outside world did, and upon no better terms. The Commission dealt with this as a specific case, and not as the application of a general rule formulating rules of conduct for reorganization managers. Consequently, it is a vital consideration that the Commission conceded that the respondents did not acquire their stock through any favoring circumstances. In its own words, "honesty, full disclosure, and purchase at a fair price" characterized the transactions. The Commission did not suggest that, as a result of their purchases of preferred stock, the respondents would be unjustly enriched. On the contrary, the question before the Commission, was whether the respondents, simply because they were reorganization managers, should be denied the benefits to be received by the 6,000 other preferred stockholders. Some technical rule of law must have moved the Commission to single out the respondents and deny their preferred stock the right to participate equally in the reorganization. To ascertain the precise basis of its determination, we must look to the Commission's opinion.

The Commission stated that "in the process of formulation of a 'voluntary' reorganization plan, the management of a corporation occupies a fiduciary position toward all of the security holders to be affected, and that it is subjected to the same standards as other fiduciaries with respect to dealing with the property which is the subject matter of the trust." Applying by analogy the restrictions imposed on trustees in trafficking in property held by them in trust for others, *Michaud* v. *Girod*, 4 How. 503, 557, the Commission ruled that even though the management does not hold the stock of the corporation in trust for the stockholders, nevertheless the "duty of fair dealing" which the management owes to the stockholders is violated if those in control of the corporation purchase its stock, even at a fair price, openly and without fraud. The Commission concluded that "honesty, full disclosure, and purchase at a fair price do not take the case outside the rule."

In reaching this result the Commission stated that it was merely applying "the broad equitable principles enunciated in the cases heretofore cited", namely, *Pepper* v. *Litton*, 308 U. S. 295; *Michoud* v. *Girod*, 4 How. 503, 557; *Magruder* v. *Drury*, 235 U. S. 106, 119-

20, and *Meinhard* v. *Salmon*, 249 N. Y. 458. Its opinion plainly shows that the Commission purported to be acting only as it assumed a court of equity would have acted in a similar case. Since the decision of the Commission was explicitly based upon the applicability of principles of equity announced by courts, its validity must likewise be judged on that basis. The grounds upon which an administrative order must be judged are those upon which the record discloses that its action was based.

In confining our review to a judgment upon the validity of the grounds upon which the Commission itself based its action, we do not disturb the settled rule that, in reviewing the decision of a lower court, it must be affirmed if the result is correct "although the lower court relied upon a wrong ground or gave a wrong reason." *Helvering* v. *Gowran*, 302 U. S. 238, 245. The reason for this rule is obvious. It would be wasteful to send a case back to a lower court to reinstate a decision which it had already made but which the appellate court concluded should properly be based on another ground within the power of the appellate court to formulate. But it is also familiar appellate procedure that where the correctness of the lower court's decision depends upon a determination of fact which only a jury could make but which has not been made, the appellate court cannot take the place of the jury. Like considerations govern review of administrative orders. If an order is valid only as a determination of policy or judgment which the agency alone is authorized to make and which it has not made, a judicial judgment cannot be made to do service for an administrative judgment. For purposes of affirming no less than reversing its orders, an appellate court cannot intrude upon the domain which Congress has exclusively entrusted to an administrative agency.

If, therefore, the rule applied by the Commission is to be judged solely on the basis of its adherence to principles of equity derived from judicial decisions its order plainly cannot stand. As the Commission concedes here, the courts do not impose upon officers and directors of a corporation any fiduciary duty to its stockholders which precludes them, merely because they are officers and directors, from buying and selling the corporation's stock.[2] The cases upon which the Commission relied do not establish principles

[2] See 1 Dodd and Baker, Cases on Business Associations (1940) 498-500, 583-86, 621-22; 1 Morawetz on Private Corporations (2d ed. 1886) §§ 516-21, pp. 482-89.

of law and equity which in themselves are sufficient to sustain its order. The only question in *Pepper* v. *Litton*, 308 U. S. 295, was whether claims obtained by the controlling stockholders of a bankrupt corporation were to be treated equally with the claims of other creditors where the evidence revealed "a scheme to defraud creditors reminiscent of some of the evils with which 13 Eliz. c. 5 was designed to cope", 308 U. S. at 296. Another case relied upon, *Woods* v. *City Bank Co.*, 312 U. S. 262, held only that a bankruptcy court, in the exercise of its plenary power to review fees and expenses in connection with a reorganization proceeding under Chapter X of the Chandler Act, 52 Stat. 840, could deny compensation to protective committees representing conflicting interests. *Michoud* v. *Girod*, 4 How. 503, and *Magruder* v. *Drury*, 235 U. S. 106, dealt with the specific obligations of express trustees and not with those of persons in control of a corporate enterprise toward its stockholders.

Determination of what is "fair and equitable" calls for the application of ethical standards to particular sets of facts. But these standards are not static. In evolving standards of fairness and equity, the Commission is not bound by settled judicial precedents. Congress certainly did not mean to preclude the formulation by the Commission of standards expressing a more sensitive regard for what is right and what is wrong than those prevalent at the time the Public Utility Holding Company Act of 1935 became law. But the Commission did not in this case proffer new standards reflecting the experience gained by it in effectuating the legislative policy. On the contrary, it explicitly disavowed any purpose of going beyond those which the courts had theretofore recognized. Since the Commission professed to decide the case before it according to settled judicial doctrines, its action must be judged by the standards which the Commission itself invoked. And judged by those standards, *i. e.*, those which would be enforced by a court of equity, we must conclude that the Commission was in error in deeming its action controlled by established judicial principles.

But the Commission urges here that the order should nevertheless be sustained because 'the effect of trading by management is not measured by the fairness of individual transactions between buyer and seller, but by its relation to the timing and dynamics of the reorganization which the management itself initiates and so largely controls." Its argument lays stress upon

the "strategic position enjoyed by the management in this type of reorganization proceeding and the vesting in it of statutory powers available to no other representative of security holders". It contends that these considerations warrant the stern rule applied in this case since the Commission "has dealt extensively with corporate reorganizations, both under the Act, and other statutes entrusted to it", and "has, in addition, exhaustively studied protective and reorganization committees", and that the situation was therefore "peculiarly within the Commission's special administrative competence".

In determining whether to approve the plan of reorganization proposed by Federal's management, the Commission could inquire, under § 7(d)(6) and (e) of the Act, whether the proposal was "detrimental to the public interest or the interest of investors or consumers", and, under § 11(e), whether it was "fair and equitable". That these provisions were meant to confer upon the Commission broad powers for the protection of the public plainly appears from the reports of the Congressional committees in charge of the legislation. The provisions of § 7 were "designed to give adequate protection to investors and consumers . . . and are in accord with the underlying purpose of the legislation to give to investors and consumers full protection against the deleterious practices which have characterized certain holding-company finance in the past." Sen. Rep. No. 621, 74th Cong., 1st Sess., p. 28. Similarly, the authority given the Commission by § 11 was intended to be responsive to the demands of the particular situations with which the Commission would be faced: "Under these subsections [11(d), (e), and (f)], Commission approval of reorganization plans and supervision of the conditions under which such plans are prepared will make it impossible for a group of favored insiders to continue their domination over inarticulate and helpless minorities, or even as is often the case, majorities . . . ." *Id.*, p. 33.

In view of this legislative history, reflecting the range of public interests committed to the care of the Commission, § 17(a) and (b), which requires officers and directors of any holding company registered under the Act to file statements of their security holdings in the company and provides that profits made from dealing in such securities within any period of less than six months shall inure to the benefit of the company, cannot be regarded as a limitation upon the power of the Commission to deal with other situations in

which officers and directors have failed to measure up to the standards of conduct imposed upon them by the Act. The Act vests in the officers and directors of a holding company registered under the Act broad powers as representatives of all the stockholders. Besides the Commission, only the management can, ~~under § 11~~, initiate a proceeding before the Commission to simplify the corporate structure and to effect a fair and equitable distribution of voting power among security holders. Only the management can amend ~~the~~ plan, and this it may do at any time; only the management can withdraw the plan, and this too it may do at will; and even after the Commission has approved a plan, it cannot be carried out without the consent of the management.

Notwithstanding §17(a) and (b), therefore, the Commission could take appropriate action for the correction of reorganization abuses found to be "detrimental to the public interest or the interest of investors or consumers." It was entitled to take into account those more subtle factors in the marketing of utility company securities that gave rise to the very grave evils which the Public Utility Holding Act of 1935 was designed to correct. See the concurring opinion of Judge Learned Hand in *Morgan, Stanley & Co.* v. *Securities Exchange Commission*, 126 F. 2d 325, 332.

But the difficulty remains that the considerations urged here in support of the Commission's order were not those upon which its action was based. The Commission did not rely upon "its special administrative competence"; it formulated no judgment upon the requirements of the "public interest or the interest of investors or consumers" in the situation before it. Through its preoccupation with the special problems of utility reorganizations the Commission accumulates an experience and insight denied to others. Had the Commission, acting upon its experience and peculiar competence, promulgated a general rule of which its order here was a particular application, the problem for our consideration would be very different. Whether and to what extent directors or officers should be prohibited from buying or selling stock of the corporation during its reorganization, presents problems of policy for the judgment of Congress or of the body to which it has delegated power to deal with the matter. Abuse of corporate position, influence, and access to information may raise questions so subtle that the law can deal with them effectively only by prohibitions unconcerned with the fairness of a particular transaction. But before transactions otherwise legal can be outlawed or

denied their usual business consequences, they must fall under the ban of some standards of conduct prescribed by an agency of government authorized to prescribe such standards—either the courts or Congress or an agency to which Congress has delegated its authority. Congress itself did not proscribe the respondents' purchases of preferred stock in Federal. Established judicial doctrines do not condemn these transactions. Nor has the Commission, acting under the rule-making powers delegated to it by § 11(e), promulgated new general standards of conduct. It purported merely to be applying an existing judge-made rule of equity. The Commission's determination can stand, therefore, only if it found that the specific transactions under scrutiny showed misuse by the respondents of their position as reorganization managers, in that as such managers they took advantage of the corporation or the other stockholders or the investing public. The record is utterly barren of any such showing. Indeed, such a claim against the respondents was explicitly disavowed by the Commission.

In view of the conditions imposed by the Commission in approving the plan, it is clear that the respondents were charged with violation of a positive command of law rather than with any moral wrong. If there had been a wrong, it would be against the stockholders from whom they purchased the preferred stock at less than the book value of the new stock—which, as we have already said, may or may not be its real value. But the Commission did not regard such stockholders as beneficiaries of the respondents' "trust" and hence entitled to restitution. The Commission did not undo the purchases deemed by it to have been made by the respondents in violation of their fiduciary obligations. Instead, the Commission confirmed the purchases and ordered that the stock be surrendered to the corporation.

Judged, therefore, as a determination based upon judge-made rules of equity, the Commission's order cannot be upheld. Its action must be measured by what the Commission did, not by what it might have done. It is not for us to determine independently what is "detrimental to the public interest or the interest of investors or consumers" or "fair or equitable" within the meaning of §§ 7 and 11 of the Public Utility Holding Company Act of 1935. The Commission's action cannot be upheld merely because findings might have been made and considerations disclosed which would justify its order as an appropriate safeguard for the interests protected by the Act. There must be such a responsible finding.

Compare *United States* v. *Chicago, M., St. P. & P. R. Co.*, 294 U. S. 499, 510-11. There is no such finding here.

Congress has seen fit to subject to judicial review such orders of the Securities and Exchange Commission as the one before us. That the scope of such review is narrowly circumscribed is beside the point. For the courts cannot exercise their duty of review unless they are advised of the considerations underlying the action under review. If the action rests upon an administrative determination—an exercise of judgment in an area which Congress has entrusted to the agency—of course it must not be set aside because the reviewing court might have made a different determination were it empowered to do so. But if the action is based upon a determination of law as to which the reviewing authority of the courts does come into play, an order may not stand if the agency has misconceived the law. In either event the orderly functioning of the process of review requires that the grounds upon which the administrative agency acted be clearly disclosed and adequately sustained. "The administrative process will best be vindicated by clarity in its exercise." *Phelps Dodge Corp.* v. *Labor Board*, 313 U. S. 177, 197. What was said in that case is equally applicable here: "We do not intend to enter the province that belongs to the Board, nor do we do so. All we ask of the Board is to give clear indication that it has exercised the discretion with which Congress has empowered it. This is to affirm most emphatically the authority of the Board." *Ibid.* Compare *United States* v. *Carolina Carriers Corp.*, 315 U. S. 475, 488-90. In finding that the Commission's order cannot be sustained, we are not imposing any trammels on its powers. We are not enforcing formal requirements. We are not suggesting that the Commission must justify its exercise of administrative discretion in any particular manner or with artistic refinement. We are not sticking in the bark of words. We merely hold that an administrative order cannot be upheld unless the grounds upon which the agency acted in exercising its powers were those upon which its action can be sustained.

The cause should therefore be remanded to the Court of Appeals with directions to remand to the Commission for such further proceedings, not inconsistent with this opinion, as may be appropriate.

So ordered.

Mr. Justice DOUGLAS took no part in the consideration and decision of this case.

SUPREME COURT OF THE UNITED STATES.

No. 254.—October Term, 1942.

Securities and Exchange Commission, Petitioner, vs. Chenery Corporation, H. M. Erskine, R. H. Neilson, et al.	On Writ of Certiorari to the United States Court of Appeals for the District of Columbia.

[February 1, 1943.]

Mr. Justice Black, with whom Mr. Justice Reed and Mr. Justice Murphy concur, dissenting.

For reasons set out in the Court's opinion and the dissenting opinion below, I agree that these respondents, officers and directors of the Corporations seeking reorganization, acted in a fiduciary capacity in formulating and managing plans they submitted to the Commission, and that, as fiduciaries, they should be held to a scrupulous observance of their trust. I further agree that Congress conferred on the Commission "broad powers for the protection of the public", investors and consumers; and that the Commission, not the Court, was invested by Congress with authority to determine whether a proposed reorganization or merger would be "fair and equitable", or whether it would be "detrimental to the public interest or the interest of investors or consumers."

The conclusions of the Court with which I disagree are those in which it holds that while the Securities and Exchange Commission has abundant power to meet the situation presented by the activities of these respondents, it has not done so. This conclusion is apparently based on the premise that the Commission has relied upon the common law rather than on "new standards reflecting the experience gained by it in effectuating legislative policy", and that the common law does not support its conclusion; that the Commission could have promulgated "a general rule of which its order here was a particular application", but instead made merely an ad hoc judgment; and that the Commission made no finding that these practices would prejudice anyone.

The Commission's actual finding was that "The plan of reorganization herein considered, like the previous plans filed with us over the past several years, was formulated by the management of Federal, and discussions concerning the reorganization of this corporation have taken place between the management and the staff of the Commission over the past several years;" that C. T. Chenery purchased 8,618 shares of preferred stock during this period; that other officers and directors of the concerns involved acquired 3,789 shares during the same period; that for this stock these respondent fiduciaries paid $328,346.89 and then submitted their latest reorganization plan, under which this purchased stock would have a book value in the reorganization company of $1,162,431.90. In the light of these and other facts the Commission concluded that the new plan would be "unfair, inequitable, and detrimental so long as the preferred stock purchased by the management at low prices is to be permitted to share on a parity with other preferred stock." The Commission declined to give "effectiveness" to the proposed plan and entered "adverse findings" against it under §§ 7(d)(1) and 7(d)(2) of the controlling Act, resting its refusal to approve on this statement: "We find that the provisions for participation by the preferred stock held by the management result in the terms of issuance of the new securities being detrimental to the interests of investors and the plan being unfair and inequitable."

The grounds upon which the Commission made its findings seem clear enough to me. Accepting as the Court does the fiduciary relationship of these respondents in managing the Commission proceedings, it follows that their peculiar information as to the stock values under their proposed plan afforded them opportunities for stock purchase profits which other stockholders did not have. While such fiduciaries, they bought preferred stock and then offered a reorganization plan which would give this stock a book value of four times the price they had paid for it. What the Commission has done is to say that no such reward shall be reaped by these fiduciaries. At the same time they are permitted to recover the full purchase price with interest. To permit their reorganization plan to put them in the same position as the old stockholders gives to these fiduciaries an unconscionable profit for trading with inside information.

I can see nothing improper in the Commission's findings and determinations. On the contrary, the rule they evolved appears

to me to be a salutary one, adequately supported by cogent reasons and thoroughly consistent with the high standards of conduct which should be required of fiduciaries. That the Commission saw fit to draw support for its own administrative conclusion from decisions of courts should not detract from the validity of its findings. Entrusted as the Commission is with the responsibility of lifting the standard of transactions in the market place in order that the managers of financial ventures may not impose upon the general investing public, it seems wholly appropriate that the Commission should have recognized the influence of admonitory language like the following it approvingly quoted from *Meinhard* v. *Salmon*, 249 N. Y. 458:

"A trustee is held to something stricter than the morals of the market place. 'Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.'"

The decisions cited by the Commission seem to me to show the soundness of the conclusion it reached. As judges we are entitled to a sense of gratification that the common law has been able to make so substantial a contribution to the development of the administrative law of this field. See e. g. *Pepper* v. *Litton*, 308 U. S. 295; *Michoud* v. *Girod*, 4 Howard 503; *Magruder* v. *Drury*, 235 U. S. 106. Of course the Commission is not limited to common law principles in protecting investors and the public but even if it were so limited the *Magruder* case would in my opinion provide complete support for the position taken by the Commission: "The intention is to provide against any possible selfish interest exercising an influence which can interfere with the faithful discharge of the duty which is owing in a fiduciary capacity. . . . It makes no difference that the estate was not a loser in the transaction or that the commission was no more than the services were reasonably worth." pp. 119, 120. The distinction now seen by the Court between these cases and the instant problem comes to little more than that the fact situations are similar but not identical.

While I consider that the cases on which the Commission relied give full support to the conclusion it reached, I do not suppose, as the Court does, that the Commission's rule is not fully based on Commission experience. The Commission did not "explicitly disavow" any reliance on what its members had learned in their

years of experience, and of course they, as trade experts, made their findings that respondent's practice was "detrimental to the interests of investors" in the light of their knowledge. That they did not unduly parade fact data across the pages of their reports is a commendable saving of effort since they meant merely to announce for their own jurisdiction an obvious rule of honest dealing closely related to common law standards. Of course, the Commission can now change the form of its decision to comply with the Court order. The Court can require the Commission to use more words; but it seems difficult to imagine how more words or different words could further illuminate its purpose or its determination. A judicial requirement of circumstantially detailed findings as the price of court approval can bog the administrative power in a quagmire of minutiae. Hypercritical exactions as to findings can provide a handy but an almost invisible glideway enabling courts to pass "from the narrow confines of law into the more spacious domain of policy." *Phelps-Dodge Corporation* v. *Labor Board, supra*, 194. Here for instance, the Court apparently holds that the Commission has full power to do exactly what it did; but the Court sends the matter back to the Commission to revise the language of its opinion, in order, I suppose, that the Court may reappraise the reasons which moved the Commission to determine that the conduct of these fiduciaries was detrimental to the public and investors. The Act under which the Commission proceeded does not purport to vest us with authority to make such a reappraisal.

That the Commission has chosen to proceed case by case rather than by a general pronouncement does not appear to me to merit criticism. The intimation is that the Commission can act only through general formulae rigidly adhered to. In the first place, the rule of the single case is obviously a general advertisement to the trade, and in the second place the briefs before us indicate that this is but one of a number of cases in which the Commission is moving to an identical result on a broad front. But aside from these considerations the Act gives the Commission wide powers to evolve policy standards, and this may well be done case by case, as under the Federal Trade Commission Act. *Federal Trade Commission* v. *Keppel & Bros.*, 291 U. S. 304, 310-312.

The whole point of the Commission finding has been lost if it is criticized for a failure to show injury to particular shareholders. The Commission holding is that it should not "undertake to decide case by case whether the management's trading has in fact

operated to the detriment of the persons whom it represents," because the "tendency to evil" from this practice is so great that the Commission desires to attach to it a conclusive presumption of impropriety.

The rule the Commission adopted here is appropriate. Protection of investors from insiders was one of the chief reasons which led to adoption of the law which the Commission was selected to administer.[1] That purpose can be greatly retarded by overmeticulous exactions, exactions which require a detailed narration of underlying reasons which prompt the Commission to require high standards of honesty and fairness. I favor approving the rule they applied.

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[1] "Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others." Report of the Senate Committee on Banking and Currency on Stock Exchange Practices, Report No. 1455, 73d Cong., 2d Sess.